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RIIO ED2 Team
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Dear Sir / Madam,

SGN – Response to ED Draft Determination

Thank you for the opportunity to respond to the Electricity RIIO-2 Draft Determination. SGN is a gas distribution network that transports gas to 5.9m customers in the Southern and Scotland licence areas. Whilst there are points of commonality between electricity and gas price controls, we recognise that each price control is determined according to the characteristics of that sector and the sector-specific evidence base. We have therefore limited our response to those points that are either potentially new policy, the treatment of inflation, or points of direct comparability to gas networks, relative risk of networks.

Treatment of Inflation

It is our view that any adjustment in the approach to allowed returns in RIIO-ED2, due to what Ofgem refers to as the inflation leverage effect, would not be an equitable/balanced approach to setting a price control and signifies significant regulatory instability, as evidenced in our response to the inflation consultation questions (FQ16-FQ18) in Chapter Four of the Finance Annex. Our response sets out why changes aren't required due to 1) the principles of RAV indexation and cost of debt allowance deflation followed by Ofgem, 2) the impact on bills of variances between outturn and long-term forecast inflation is over multiple price control periods rather than a concentrated short-term bill impact and 3) there is no inherent reason to believe that over the long-run, out-turn inflation should be expected to be systematically above or below the long-term forecast on average.

Furthermore, the inflation leverage effect referred to by Ofgem is a risk borne by companies and their investors. This is a risk that companies can choose to mitigate (or not) by managing the proportion of their debt linked to inflation. Networks will have chosen how best to respond to or mitigate the risks they face and will have different strategies when it comes to hedging inflation exposure. These strategies will have been established and implemented over many years.

Notwithstanding SGN's view that an adjustment mechanism is not required, should one be proposed it would require a substantial assessment to fully evaluate the impacts and to avoid unintended consequences. Furthermore, networks would require appropriate notice (i.e. many years) of the implementation of any mechanism in order to adjust their financing and risk management strategies. Therefore, SGN does not support an adjustment in the approach to allowed returns in RIIO-ED2.

Relative Risk of Networks

The issue of relative risk of energy subsectors is raised in Chapter Three of the Finance Annex, including questions on relative risk (FQ7 and FQ8). Whilst we expect the relative risk of gas distribution to be addressed in the RIIO-GD3 process it is appropriate to state that SGN strongly believes that gas companies face greater risk than electricity companies due to them facing the unique and existential risk of significant asset stranding if there is substantial electrification of heat due to Net Zero.



This means that gas networks and investors face the risk of customer numbers dramatically reducing and under-recovery of the RAV.

We have responded to questions FQ16-FQ18 below. Please consider these responses alongside the Frontier report 'Inverse Inflation Exposure – Response to ED2 Draft Determination', which has been submitted on behalf of networks by the ENA. If there are any questions then please contact us.

Yours sincerely,

David Handley
Director of Regulation



FQ 16. Do you think we should adjust our approach to allowed returns (noting our approach to expected inflation for WACC and outturn inflation for RAV as described above) so that outturn inflation does not permit the notional company to generate real equity returns that are materially higher or lower than our cost of equity allowance? What would be the consequences to consumers and DNOs of doing so?

The regime of applying a real WACC to a RAV indexed to outturn inflation has been a cornerstone of energy network regulation since privatisation. The real WACC is calculated using long-term inflation measures to deflate from nominal benchmarks. In the case of the cost of debt allowance, this long-term inflation assumption is used to align with the inflation element of the nominal coupon rates in the iBoxx benchmark, via a trailing average. This methodology, therefore, provides a real cost of debt allowance that reflects the real cost of debt element of the benchmarked debt.

Of course, in the past and going forward, there will be positive and negative differences between the year-on-year outturn inflation used to index the RAV and long-term inflation expectations. However, Ofgem in raising this as a concern is incorrectly conflating two of its principles:

- historically invested capital (RAV) needs to be adjusted to today's value (by using actual outturn inflation); and
- the real cost of debt allowance needs to be derived by adjusting the nominal coupon on long-term debt using a forecast long-term inflation assumption that broadly matches the inflation element of actual long-term debt issuance, which is based on long-term inflation expectations.

While it is to be expected that there are periods of time when outturn inflation will be above or below the OBR's year-5 inflation forecast that Ofgem use, there is no inherent reason to believe that over the long-term, on average, inflation should be expected to be systematically above or below that forecast. Investors have invested on this basis.

Introducing an adjustment mechanism in a period of higher outturn inflation immediately following a sustained period of low inflation in RIIO-1, would be highly opportunistic and lacks regulatory credibility. It would also signal regulatory uncertainty/instability and be a significant deterrent in attracting the investment needed for the transition to Net Zero.

Furthermore, any temporary under/over recovery arising from inflation exposure will only flow through into cashflows (hence customer bill levels) over a long-time horizon, i.e. accruing in the RAV before being released through depreciation of and return on RAV. The customer bill impacts, of the variance between forecast and outturn inflation, are therefore spread over the long term rather than being concentrated in the short term.

It would be reasonable for investors to conclude that Ofgem is willing to row back on past decisions in circumstances where investors bore risks that worked in their favour, but unwilling to change its methodology in circumstances where investors bore risks that worked against them. Since this form of regulatory design (i.e. to fix an allowance in the expectation that ex-ante is fair, around which the outturn may in practice vary) is not uncommon in the price control framework, investors will naturally wonder where such opportunism will emerge next.

Risks should be allocated to those best able to manage them. While the level of outturn inflation is beyond the control of networks and customers, networks are able to mitigate (subject to market demand in appropriate inflation formats) the impact of inflation through structuring their debt portfolio to be inflation-linked. This would mean that their debt and interest payments vary with outturn inflation and thus be aligned with the indexation of the RAV. Alternatively, networks can choose to have greater exposure to inflation risk by having a lower proportion of index-linked debt, which will lead to an over or under recovery of nominal borrowing costs depending on whether outturn inflation is above or below the long-term forecast.

These are factors that Ofgem have long appreciated, as shown in the following extract from the GD1 process:

'The approach used to calculate the cost of debt index implicitly assumes that all network debt is index-linked. In reality, only a small proportion of the networks' debt is index linked and the networks are exposed to inflation risk on the rest of their debt profile'¹

¹ Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Financial issues, para 3.55



Also, Ofgem has published specific decisions in the RIIO-GD2/T2 & ED2 processes² that long-term inflation assumptions should be used in cost of capital parameters, including to deflate a cost of debt index (using the long-term OBR forecast).

Ofgem has, like with the rest of the price control package, decided in advance which risks networks should carry. Where the regulator decides a risk is better 'managed' by networks, they are exposed to any downside outturns but equally benefit from any upside outturns. As financing decisions are a matter for individual companies (which is a long-established Ofgem position), each network chooses how much of this risk to accept and how much to mitigate through their own decisions regarding the proportion of their debt that is inflation-linked (and/or inflation hedged e.g. using derivatives). We note the RIIO-ED2 Draft Determinations remain in favour of this approach, for example;

*"The notional company approach reflects the principle that companies and their investors are best placed to bear the risks associated with their borrowing choices."*³

Additionally, the narrative in chapter four of RIIO-ED2 Draft Determination Finance annex does not consider that in the current period of high inflation there are notable CPI-CPIH and RPI-CPI wedges. These have a significant impact on notional company debt costs, as Ofgem only provided an allowance to cover a very small degree of variation in the expected RPI vs CPI wedge; and no allowance for any variance between CPI vs CPIH.

Networks' debt portfolios are built up over time and are generally long-dated. If Ofgem were to change the system for RIIO ED2 – despite signalling to date that it was not going to do so, Ofgem would be imposing an entirely different risk profile on investors to the positions they had believed they were adopting.

The time between the Draft Determination and the start of RIIO ED2 would not be sufficient for networks to adapt debt portfolios to re-balance this risk efficiently in light of any new arrangements – particularly as Ofgem has not yet proposed any specific change. It would also damage investor confidence in the transparency of regulation, where material changes are generally given long signalling periods of many years to allow sufficient time to prepare and adapt.

Furthermore, financing and risk management decisions may well have been made on the basis of how these decisions impact KPIs, such as credit metrics. Therefore, sudden changes could have significant impacts.

This is a complex area that needs careful consideration to avoid unintended consequences. The existing treatment of inflation is deeply embedded within the mechanics of the price control and any efforts to review or amend that treatment would need to be done with extreme caution involving substantial analysis and consultation. There would also need to be full stress-testing of how any mechanism implemented may work in practice. The RPI-CPI and CPI-CPIH wedges exposures highlighted above are an example of unanticipated consequences.

We note that Ofgem's RIIO-ED2 Draft determination is suggesting that it is simply seeking to provide 'similar protection in extremis for consumers in the event of high inflation' to what it already provides for network investors in the event of extreme circumstances such as low inflation.⁴ As set out in Frontier's report⁵, submitted by the ENA, Ofgem's referencing of two documents to support this is inaccurate as neither refer directly to any support that would be provided to energy networks in periods of low inflation, if they had taken on inflation exposure by issuing fixed rate debt.

Any adjustment in the approach to allowed returns in RIIO-ED2 would not be an equitable/balanced approach to setting a price control and signifies significant regulatory instability. Substantial assessment is needed of any potential changes, which SGN don't think are required due per se due to 1) the principles of RAV indexation and cost of debt allowance deflation followed by Ofgem, 2) the impact on bills of variances between outturn

² Ofgem RIIO GD2/T2 Sector Specific Methodology Decision Finance Annex, para 2.85; Ofgem RIIO GD2/T2 Sector Specific Methodology Decision Finance Annex, para 3.39-3.40; Ofgem RIIO GD2/T2 Draft Determination Finance Annex, para 2.75; Ofgem RIIO ED2 Sector Specific Methodology Decision Finance Annex, para 2.66

³ Ofgem RIIO-ED2 Draft Determinations – Finance annex, Para 2.4,

⁴ Ofgem RIIO-ED2 Draft Determinations – Finance annex, Para 4.8.

⁵ Frontier Inverse Inflation Exposure – Response to ED2 Draft Determination, p9-10



and long-term inflation forecasts is over multiple price control periods rather than a concentrated short term impact and 3) there is no inherent reason to believe that over the long-run, out-turn inflation should be expected to be systematically above or below the long term forecast on average. Networks would require appropriate notice (i.e. many years) of the implementation of any mechanism (notwithstanding SGN's view that they aren't required) so they can adjust their financing and risk management strategies, and therefore SGN does not support an adjustment in the approach to allowed returns in RIIO-ED2.

FQ 17. If you believe we should make such an adjustment, what is the best method for making it?

We don't believe any adjustment in the approach to allowed returns should be made in RIIO-ED2. As set out in our response to FQ16 this is because it is not an equitable/balanced approach to setting a price control, ignores the significant complexities and interlinkages of inflation indexation being so embedded within the price control framework and signifies significant regulatory instability.

Furthermore, substantial assessment is needed of any potential changes, notwithstanding SGN's view that they aren't required per se due to 1) the principles of RAV indexation and cost of debt deflation followed by Ofgem, 2) the impact on bills of variances between outturn and long term inflation forecasts is over multiple price control periods rather than a concentrated short term impact and 3) there is no inherent reason to believe that over the long-run, out-turn inflation should be expected to be systematically above or below the long-term forecast on average. Networks would require appropriate notice (i.e. many years) of any amendments that result from an assessment process, so they can adjust their financing and risk management strategies, and therefore SGN does not support an adjustment in the approach to allowed returns in RIIO-ED2.

FQ 18. If you don't believe we should make such an adjustment, how should we ensure that the fairness of the price control is maintained to prevent ex post returns from deviating from ex ante expectations for both consumers and investors?

As evidenced in our response to FQ16, the fairness of the price control would not be maintained if such an adjustment was introduced in RIIO-ED2. This is because it's not an equitable/balanced approach to setting a price control, ignores the significant complexities and interlinkages of inflation indexation being so embedded within the price control framework and signifies significant regulatory instability.

We note Ofgem did not consider the current approach unfair when consumers benefitted from the difference between forecast long-term inflation and actual out-turn inflation in RIIO-GD1.

SGN's view is that adjustments aren't required per se due to the 1) the principles of RAV indexation and cost of debt deflation followed by Ofgem, 2) the impact on bills of variances between outturn inflation and long-term forecasts is over multiple price controls rather than a concentrated short term impact and 3) there is no inherent reason to believe that over the long-run, out-turn inflation should be expected to be systematically above or below the long-term forecast on average. Should an adjustment be proposed by Ofgem it would require substantial assessment and networks would require appropriate notice (i.e. many years) of any amendments that result from the assessment process, so they can adjust their financing and risk management strategies.

Furthermore, the text of question FQ18 implies that it is unfair if ex-post returns deviate from ex-ante expectations, yet Ofgem already allows for and anticipates ex-post returns deviating from ex-ante expectations, as a result of risks borne by investors, elsewhere in the price control package. For example, Ofgem believes investors should be exposed to the risks and returns from companies' financing choices.⁶

The inflation leverage effect referred to by Ofgem is a risk borne by companies and their investors and that is why no such adjustment is required. This is a risk that companies can choose to mitigate (or not) by managing the proportion of their debt linked to inflation – subject to market demand in appropriate inflation formats. Networks will have chosen how best to respond to or mitigate the risks they face and will have different

⁶ Para 2.4, Ofgem RIIO-ED2 Draft Determinations – Finance annex



strategies when it comes to hedging inflation exposure. These strategies will have been established and implemented over many years. It would be inappropriate for Ofgem to now change such long-established practice for indexation of the RAV and setting of the WACC. Notwithstanding this point, if a change is to be made it should be signalled well in advance (i.e. in many years) so networks can plan accordingly.