

31 October 2021

Ofgem Open Letter on the next network price control review process - Northern Gas Networks response.

We welcome the opportunity to comment on Ofgem's Open Letter and are pleased that Ofgem has highlighted the key question regarding what form of regime is appropriate for RII0-3 and into the future. We agree with Ofgem that significant consideration should be given to what is needed to ensure that regulatory frameworks remain fit for purpose and are implemented in the best interests of current and future consumers. This response sets out Northern Gas Networks' thoughts and proposals. We look forward to working with Ofgem on these important issues over the coming months and years and will provide further input as Ofgem develops its plans.

In addition to the process review being undertaken by Ofgem, we consider that any reform cannot be undertaken independently from the considerations underway at BEIS in relation to economic regulation more broadly. Regulatory reform is an area of key government interest and any proposals developed by Ofgem and the industry need to be compatible with broader institutional architecture changes envisaged by the government.

We broadly agree with the strategic issues that Ofgem has identified in its Open Letter. 'The impacts of these changing dynamics include - crucially for companies in the gas sector - the role of hydrogen in heating'. It is essential that we collectively give ourselves the necessary time to develop regulatory approaches that can adapt and endure and critically that stakeholders have the opportunity to provide meaningful input into the process.

The development of any Whole Energy System regulatory framework must begin with bringing all elements of that framework together on a consistent basis and timeframe. We consider that this can most effectively be achieved by implementing a two-year extension to RII0-GD2 and T2 and that this should be taken forward by Ofgem as a priority.

In addition to providing the time to conduct this important framework development activity, an extension will allow networks to:

- Incorporate key government policy decisions regarding heat into our planning. This will reduce (but not eliminate) uncertainty as we head into the next full control period and allow us to better understand the role of the FSO as a planning body.
- Align the price controls across all network sectors. This is essential if we are to truly realise the whole-system approach that Ofgem advocates.

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Ofgem has outlined the majority of the key questions that need to be addressed in considering any case for change to the regulatory framework. However, we are mindful that the RIIO framework is still relatively new and an overhaul of the whole framework before there is more certainty about the future public policy choices to be made by government could further undermine investor confidence. Additionally, in the near-term, we consider that our core role in the operation of the gas distribution networks will not be fundamentally different. Thus providing further support for taking the necessary time to consider the detailed case for changes to the current framework and its effective application.

Beyond RIIO-3, we consider that a more flexible and adaptable framework than RIIO is required to accommodate the transformative change that the energy networks must implement to deliver the UK Net Zero commitments, and which we consider is incompatible with a five-yearly revenue reset. We include in this response an outline proposal for a reformed set of arrangements incorporating enhanced ex post elements. We consider that aspects of this new arrangement could be trialled by the leading network companies, including Northern Gas Networks, in the RIIO-3 period.

In the development of any new regulatory arrangements, a clear focus on principles will be key. Our response sets out a framework for assessing any proposed reforms. The principles that the framework needs to incorporate are the ones at the heart of UK economic regulation – a focus on incentives, customer value and simplicity.

Getting the regime right for RIIO-3 and beyond is vital to facilitating the investment needed to meet our Net Zero commitments. All stakeholders need to be given the time to consult and develop proposals for future regimes. We want to work closely with Ofgem on this and consider that our proposals represent the best way forward.

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Q1: Do you have any views on the strategic issues we must consider in the development of the next price control review process?

Summary of key points:

- Significant uncertainty exists in the energy sector and greater clarity through government policy, development of new roles such as the FSO and implementation of BEIS' regulatory reform agenda will help minimise that uncertainty. This will not happen prior to the next price control.
- We must allow ourselves the time to develop the right regulatory solutions for the development of new regulatory approaches. Given the pace at which proposals may be developed by government, and the impact of the current energy crisis, we consider that a two-year extension to the current price control would be appropriate to allow more clarity of what would be the needs and challenges for RII0-3; effectively, rolling-over the RII0-2 control for two additional years
- Uncertainty will still exist, but a well-developed and adaptable set of proposals will create a sound basis for allowing each network sector to evolve with a consistent and whole-system focused approach.

We agree that Ofgem has identified many of the most significant strategic issues facing the energy sector.

Of particular significance to the gas sector is a key government decision on decarbonisation of heat, and the role of hydrogen as part of this. This decision is expected in 2026 – the first year of the next price control as currently scheduled. We consider that it is becoming increasingly clear that hydrogen will be an essential part of the UK's future energy mix and indeed that Net Zero will not be achieved without hydrogen playing a major role.¹ The future price control arrangements must reflect this reality, enabling investment necessary to keep all reasonable energy pathways on the table.

Though the 2026 decision is clearly an important milestone, we should not assume that it will resolve all outstanding uncertainty that the sector faces. Furthermore, the ongoing energy crisis shows us that not all uncertainties we face can be confidently predicted or understood in advance. The regulatory structures we set out to design now should be future proofed to handle the uncertainties we will face over a much longer timeframe.

¹ The [UK Hydrogen Strategy](#) states that "Low carbon hydrogen will be critical for meeting the UK's legally binding commitment to achieve net zero by 2050, and Carbon Budget Six in the mid-2030s on the way to this."

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Ofgem also highlights the potential future role of the FSO, which we expect will in due course bring together planning responsibilities for both electricity and gas systems, including strategic network planning for the gas sector. Until the precise role of the FSO and the nature of its interaction with the regulatory framework become clear, the changes to the regulatory structures arising from the creation of the FSO should be regarded as another facet of uncertainty that the price control should be equipped to accommodate.

Another relevant development in this regard needs to be taken into account - the publication earlier in 2022 by BEIS of its Economic Regulation Policy Paper.² The clear direction of travel implied by this publication is a reduction of variation in approach across the different regulated sectors. This is proposed to be achieved through a rationalisation of statutory duties and appeal frameworks as well as more consistent price control frameworks and closer working between regulators via the UK Regulators Network. The paper also envisages that the government may issue strategic guidance to the regulators to provide greater clarity on their role within the framework. This, together with the proposed review of regulatory duties, represents further uncertainties that should be taken into account in arriving at a decision on future price control arrangements.

Extension of RIIO-GD2 arrangements

The strategic challenges facing the gas distribution sector, high-lighted by Ofgem in the Open Letter and expanded on above, are significant and complex and we must allow ourselves the time to jointly develop regulatory approaches that are fit for purpose. The last time Ofgem took a step back and conducted a root-and-branch review of regulatory models was RPI-X@20. This was a valuable exercise in exploring different regulatory options, through which the RIIO model was developed. It is notable that this review took place over a period of more than two years in 2008-2010 and the resulting framework, RIIO, has only been in place for one full price control (and 10 years overall).

Taking into account the expected developments in the energy sector, together with the complex nature of the strategic issues we face, we consider that it is both logical and practical to consider that the RIIO-GD2 and T2 arrangements should be extended by two years to 2028.

The key benefits of this include:

- Allow sufficient time for a thorough and robust process to review regulatory framework options. If we attempt to carry out a broad review of the regulatory framework within the confines of the normal price control timeline, we risk being timed out or rushing into options that have not been properly tested or impact assessed.

² [Economic Regulation Policy Paper](#), BEIS, January 2022

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- Ensure that we do not go “too far, too fast”. It is important that all stakeholders including investors have an opportunity to input and that regulatory stability is preserved and enhanced through any change to the regime.
- Align the Gas and Electricity Distribution and Transmission price controls which will help facilitate the whole system planning that is required to meet the UK’s Net Zero targets and the consistency of delivery required to achieve the maximum benefits arising from whole system planning. This alignment will allow for application of consistent scenario assumptions across sectors to be factored in to Ofgem’s determinations.
- Reduce (but not eliminate) uncertainty as we head into the next control period, with the planned announcement of key government policies regarding heat in 2026 as well as further development of the FSO.

An extension of RIIO-2 could broadly continue with the existing control arrangements in place, with the focussed review of certain elements, including workload-driven Totex allowances, Uncertainty Mechanisms (UMs) and key parameters of the Cost of Capital allowance.

Extension of RIIO-2 should be consulted upon separately and we would welcome the opportunity to work with you in the development of these proposals.

Q2: Do you have any views on the case for change we have outlined?

Summary of key points:

- We consider that the RIIO arrangements – with some improvements and exceptions for the frontier companies - should remain in place for the price control that follows RIIO-2.
- The regulatory framework - and in particular the approach to managing uncertainty - must change to facilitate greater no- and low-regret investment to keep pathways to Net Zero open. This should be reviewed as a priority.
- Ofgem should follow through more strongly on its goal to put the consumer voice at the heart of the price control process, placing a greater weight on the views expressed by our stakeholders.
- The RIIO controls have become unnecessarily complex. The arrangements can and should be simplified without risk of consumer detriment.

Ofgem’s Open Letter correctly identifies several external drivers for change that give reason to take stock of whether aspects of the current regulatory frameworks are optimal moving forwards.

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In the shorter term, a refined version of RIIO will be fit for purpose

We must not lose sight of the fact that, for the next price control period, the day-to-day operation of the gas distribution networks is not likely to be significantly different to the present situation.

The core tenets of RIIO – innovation, incentives and outputs (properly tied to the revenues networks are entitled to recover from customers) – are at least as relevant as they were when the RIIO framework was designed. The RIIO regime and its predecessors have ultimately been successful in allowing the sector to secure the necessary investment needed to operate a gas network that is safe, efficient, resilient, and reliable. We consider that the RIIO arrangements – with some refinement and simplification - should remain in place for the price control that follows RIIO-2, except for the frontier companies, which could warrant a different treatment from RIIO-3 (to be discussed in response to Q4).

Beyond the RIIO-3 period, we do consider that a much more flexible and adaptable approach, and a shift away from some elements of the current RIIO framework may be required. Fundamentally, this is because we do not consider that periodic, five-yearly resetting of revenues reviews will be suitable for a sector undergoing the transformative change and investment that is required to deliver the UK's Net Zero commitments.

We propose an alternative approach in our response to Q4, aspects of which could be trialled by leading companies (such as Northern Gas Networks) as part of RIIO-3.

The balance of risk needs to be recalibrated

Ofgem identifies the balance of risk as a feature of RIIO-2 that may benefit from adaptation. We whole heartedly agree and consider this is key to ensuring the lowest whole-system cost in the energy system transition. Addressing issues connected to the balance of risk is perhaps the most significant reform objective for the next price control. Prioritisation of short-term costs in the face of uncertainty at the expense of all other considerations is ultimately not in the consumer interest.

Uncertainty Mechanisms (UMs) have been and will remain a necessary component of the price control framework. However, UMs as applied at RIIO-2 generally operate under the principle that additional funding is available once the investment need crystallises. This “wait and see” approach does not directly address the difficult decisions that networks face and raises the prospect of deliverability issues as a result of back-loading required investment in the sector. Waiting for certain investment needs to materialise and subsequently allowing funding through UMs is an approach that specifically does not fully address the uncertainty that the sector faces - and one that ultimately risks consumers paying more than they should in the long-run. There is a very real and significant cost of doing nothing.

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The regulatory framework must change to be more agile to facilitate greater no and low-regret investment to keep lower cost pathways to Net Zero open. This should be reviewed as a priority.

Stakeholders' views must be reflected better in the process

At RIIO-2, Ofgem placed an increased emphasis on 'enhanced engagement' – requiring the establishment of Customer Engagement Groups (CEGs) and raising the bar in respect of stakeholder inputs into the business planning process. NGN accepted this challenge, delivering a customer-centred business plan, with a high degree of support both from customers and our CEG. Final determinations made by Ofgem at RIIO-GD2 reflected a reluctance on its part to act upon the clearly expressed views of stakeholders, despite demonstrable support for our plan from our customers and CEG.

We consider that Ofgem should follow through more strongly on its goal to put the consumer voice at the heart of the process, placing a greater weight on the views expressed by our customers and CEG.

Successful delivery of the UK's Net Zero commitments will require not only effective co-ordination across the gas and electricity sectors but also with Local Authorities and Stakeholders. Approaches to investment may require greater regional variation than previously. Ofgem must ensure its consideration of company plans is able to accommodate these very different local and regional needs, within a framework that is clearly understood by all parties.

RIIO has become too complex

The RIIO price controls have grown complex with significant additional administration and multiple parties involved in making decisions, however, simplification can be achieved without fundamental reform of the price control framework for RIIO-3.

We note that Ofgem started out the RIIO-2 process with "simplifying the price control" being a main objective. In this respect, the RIIO-2 process was not a success, as it resulted in the most complex set of price control arrangements seen to date in any regulated sector in the UK. At RIIO-2, changes made in the name of simplifying the price control included:

- Removing the information quality incentive and fast-tracking mechanisms and replacing them with the lower strength business plan incentive (BPI), which was difficult to interpret given its relative complexity and limited guidance made available. In the case of the BPI, in its most recent application in the Electricity Distribution sector (at DD stage), four of the six DNOs receive no reward or penalty at any of the BPI's four stages and only two DNOs receive a penalty or reward, yielding a sector aggregate reward of just £2 million.

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- Application of the Confidence-Dependent Incentive Rate, which has resulted in all GDNs and all DNOs (at DD stage) being assigned Totex Incentive Mechanism (TIM) rates at or above 49% out of a maximum 50%, largely on the basis that an econometric model has been applied at the totex level in arriving at allowances and therefore all costs are to be considered “high confidence”.

In both examples, the outputs of these processes has recognised virtually no differentiation between companies’ proposals. We can see little demonstrable customer value as a result.

For RIIO-3, we agree that Ofgem should revisit, and this time follow through on its aim to simplify the RIIO arrangements, but we do not consider that this in itself necessitates wholesale changes to all or major aspects of the RIIO framework.

Q3: Do you have views on whether the changes to the electricity or gas sectors mean that there is a case to consider alternatives to the approach taken in the RIIO-2 price control?

Summary of key points

- For RIIO-3 the framework needs to be simplified to make it more agile and less resource intensive for companies and the regulator.
- Reducing regulatory complexity should not drive a narrow focus on short-term cost savings.
- A well-designed and enhanced ex post regime could help the industry navigate uncertainty and lean into transformational change.

The RIIO framework has been in place for almost ten years, and despite having been re-evaluated previously, it is appropriate to take this opportunity to review its role and fitness for purpose, and to consider alternative options. However, this review needs adequate time given the complexity involved.

Whilst we do not consider that a compelling case for change has been made for a wholesale move away from a RIIO-type framework in the shorter term, there is a clear case to reduce complexity and increase flexibility. Furthermore, the strategic issues highlight the increasing need to take account of different sector and company requirements, for example, to address unique sector uncertainties, local Net Zero priorities, or regional differences in preparing for gas blending, hydrogen conversion, or decommissioning.

Ongoing dialogue in the lead up to publication of the framework consultation will be essential in ensuring that all viable options for future development remain on the table. This dialogue will also be necessary to ensure that the forthcoming consultation contains sufficiently

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detailed proposals to allow us to take meaningful steps forward in the design of any reformed framework.

The Open Letter proposed four potential future regulatory framework models. Below, we set out our initial observations on each of the options.

- *Option 1: Adapted form of RIIO.* Periodic reviews can provide enhanced stability and incentive properties, as well as the opportunity to periodically rebase the framework to capture performance improvements and emerging priorities. However, a notional period, five-years or otherwise, can restrain flexibility and transformational change, especially given the substantial time required to plan and set a price control. Furthermore, Ofgem rightly recognises that the RIIO process has become resource intensive, although this has more to do with its implementation than its principles. **The existing RIIO framework can continue to be effective in the shorter term for core network activities, but it needs to be simplified and made more agile to address inherent uncertainties in the energy sector.**
- *Option 2: Ex-ante based on an operating efficiency incentive.* A simpler focus on efficiency could reduce complexity but not necessarily regulatory burden. A short-term focus on cost efficiency would also risk longer-term consumer benefits, which is especially important for an industry that is focused on safety and service provision until greater clarity about the future direction for the sector is known. It is also not clear how a productivity incentive would work in practice, given the complex data and assessment required to measure pure productivity without distortion from other factors. Overall, it is right to seek to reduce framework complexity, but doing so should not come at the expense of longer-term benefits. **We do not consider Option 2 a high priority model for development.**
- *Option 3: A model involving greater user/stakeholder participation.* It is important that consumers are empowered to have a say in their energy infrastructure, and, during RIIO-2 business planning, gas customers helped define Northern Gas Networks' plan through extensive engagement. However, a more extensive form of negotiated settlement would require a step change in commercial engagement between companies and stakeholders, which would not be straightforward when it comes to energy networks. Nor would it necessarily allow Ofgem to delegate or transfer substantial aspects of industry scrutiny and decision making to other parties. Overall, to the extent that network companies can access a diverse, engaged, and informed cross-section of their customer base, and provided Ofgem is willing and able to recognise the outcomes of such engagement, user participation should continue to *support* the next framework. **We do not consider Option 3 a high priority model for development.**

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- Option 4: *Ex post*. RIIO already has several *ex post* features, but typically these are overlaid onto an *ex ante* baseline (e.g. evaluative PCDs and close-out), which increases regulatory complexity without increasing flexibility. A purer form of *ex post* regime could, by virtue of being less prescriptive and resource intensive than an *ex ante* regime, provide the industry with greater flexibility to navigate uncertainty and lean into transformational change. A well-designed and enhanced *ex post* regime should still provide the appropriate incentives to innovate and to seek superior consumer outcomes. For the avoidance of doubt, we do not advocate for the rate-of-return regulation, which is unlikely to achieve the above objectives. **We propose a form of enhanced *ex post* regime for further development as part of Ofgem’s review, as discussed in our response to Q4.**

Q4: Are there any broad frameworks or options that you think we should consider, including variants and alternatives to those we set out

Summary of key points

- A form of *ex post* framework which retains incentives and enables companies to operate flexibly and innovate should be a priority for Ofgem.
- It must preserve some basic principles such as risk return equilibrium but should be focused on consumer value.
- Incentives may need to be stronger, particularly for companies at or close to the frontier to ensure innovation and improvements continue to be made
- The new regulatory paradigm would help build a mutual trust between regulated company and regulator
- Customers can be safeguarded, and legitimacy preserved through ensuring returns remain within acceptable tramlines

The revised framework should be grounded in Ofgem’s principal objective to deliver on protecting the interests of customers, both existing and future.³ It should promote efficiency (in the widest sense) whilst allowing the sector to remain investable and financeable in the context of the overall architecture. It should be assessed against the principles of revealed efficiency not only within a single regulatory period but as part of a longer-term regulatory contract, spanning multiple price control periods.

³Gas Act, 1986 – Section 4AA(1) (as amended)

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The success or failure of the framework should not be assessed based on RoRE alone but on a revised measure more aligned with these underlying statutory duties. Those companies which deliver the highest levels of consumer value would represent the best overall performers and the incentive construct under the regulatory regime should be designed to help ensure an enhanced level of consumer value was delivered.

This consumer value would be most enhanced through careful consideration of the sharing factor within the regulatory construct between companies and customers to help ensure focus on innovation and investment. The closer to the frontier a company is, the more highly powered incentives need to be to deliver overall efficient outcomes - this may affect consideration of sharing rates for the Totex Incentive Mechanism (TIM) – and on a dynamic basis.

The framework must be structured around a risk return equilibrium. This is particularly important when considering *ex post* frameworks and *ex post* adjustment which will be subject to higher levels of risk in terms of after the-event application of regulatory discretion. Where frameworks have elements of asymmetry introduced, this should be adjusted for elsewhere in the overall arrangements.

Taking into account the above, any revised framework must give consideration to:

- the issue of legitimacy on behalf of the regulated energy networks in terms of the service levels which consumers can reasonably expect and how the frameworks continue to support the delivery of that service.
- the role of the regulator to determine outcomes and/or to create incentive frameworks which help ensure the regulated entities deliver optimal outcomes and to seek to protect against abuse.
- the role of consumers and stakeholders, including the role of the policy maker and of ensuring accountability to societal outcomes. This is a role that is likely not best served by Ofgem so needs wider input.

A form of enhanced ex post framework which retains incentives and enables companies to operate flexibly and innovate should be a priority for Ofgem. It would embed and deal with the uncertainties in a manner which enables companies to adequately respond and to innovate.

The overall level of uncertainty in the sector which Ofgem has highlighted in the Open Letter equally requires a change in the level of regulatory risk appetite. Within the new paradigm, and in the presence of greater uncertainty, it will be important when it comes to considering allocative efficiency, that all costs are taken into account including the costs of delay, and the cost of doing nothing.

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Our proposal

A system that has clear “tramlines”, built around a RAMs-type mechanism limiting the degree of over- or under-performance for a company, with rewards and penalties around delivering what customers want and value could enable a simpler and more flexible regulatory regime than that currently employed.

Under this approach:

- Ofgem would set an allowed RoRE range, monitor company delivery of outcomes (with input from qualified partners) and periodically update incentive rates.
- High-performing companies, measured by reference to consumer value delivered, would earn RoRE returns towards the top end of the allowed range and poor performers at the bottom of the range.
- Companies are permitted to determine their own expenditure and revenues on the proviso that the outturn RoRE remains within the range set by the regulator and subject to the regulator’s review of the consumer value derived outcomes.
- Ofgem could also undertake economic purchasing reviews if costs either breach some simple rules or substantiated concerns about the costs are raised.

For such a regime to be successful the rules by which regulatory interventions would occur need to be clearly established from the outset. There would need to be a time-bound review of the operation of the system – the same five-yearly cycle as at present could be retained.

We consider that such a framework would:

- Be flexible, allowing companies to better adapt to the changing circumstances of the sector.
- Drive companies to innovate and engage with customers through continued incentivisation of key performance areas.
- Free up regulatory resources to focus on priority areas.

Eligibility for this new regime could be based on the application of a set of minimum requirements. This could follow a process similar to that used when determining eligibility for fast-track status at previous price reviews. Northern Gas Networks would be willing to trial such a regime, having proven our commitment to being at the frontier of performance, efficiency, and customer value. NGN will develop this concept further and will engage with Ofgem in the lead up to the proposed RIIO-3 consultation scheduled for early 2023. We consider that there is merit in progressing this proposal and look forward to working with Ofgem over the coming months and years to develop a suitable process through which

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network companies can efficiently and effectively meet the strategic challenges faced by the energy industry whilst continuing to deliver consumer value.

If there are any queries or further discussions that you would like to have with NGN in relation to our response, please don't hesitate to contact me via email gdodd@northerngas.co.uk. We look forward to working with Ofgem on developing the next price control process. .

Kind Regards



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