

Reference

Open letter on the next network price control review process

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Dear Akshay,

Open letter on the next network price control review process

It is essential that we have the right price control framework in place to deliver long-term value for our customers by enabling an agile and efficient transition to net zero.

In our *Developing the Green Print for Economic Regulation: RIIO for 2050* document, published earlier this year, we set out our view that the framework of today may need to significantly evolve to support the energy transition. We are therefore pleased to see the broad approach Ofgem intends to take to consider what changes may be needed and the specific recognition of points we have raised. Notably to: instil greater levels of whole-system planning, navigate key uncertainties and simplify price controls processes.

The aspirations set out in the Open Letter, however, will likely require considerable change and there is a real issue as to whether this is deliverable – particularly within the time-frame available. This does not mean that we believe that the next price control should be deferred in some way simply to buy more time to deliver a very different framework. Rather, Ofgem should significantly simplify approaches to the setting and administration of price controls where possible now, to allow greater resource to be devoted to designing and implementing new approaches.

We have a number of observations to make on the strategic issues reflected within the Open Letter and the high-level options put forward for how price controls could evolve. These are summarised below, with detailed responses to your consultation questions in the Appendix to this letter.

Strategic issues

It is important to ensure that an equal focus is put on both gas and electricity networks if we are to develop the best solutions for customers to deliver an affordable and secure energy transition. With this in mind, we do not believe the Open Letter gives sufficient recognition to the inevitable major transformation of gas networks required over the coming decades. For example, while gas impacts are referenced, hydrogen is 'out of scope' of potential reforms. Given hydrogen has already been confirmed to play an essential role to decarbonise industry and power (supporting Government's British Energy Security Strategy to produce 10GW of hydrogen by 2030) and is also likely to play a vital role in heat, it is critical for future price controls to support its adoption.

There is also no direct mention of Government's Heat Policy decision, currently set for 2026, which – no matter the outcome – will fundamentally change what gas and electricity networks need to deliver to meet net zero (either through re-purposing of networks for hydrogen, greater electrification and/or some decommissioning of existing networks). Therefore, the next price control, due to start concurrently to or only a matter of months in advance of this, must ensure that networks are able to swiftly react to Government's direction.

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The case for change

While the Open Letter sets out a compelling case for change, leading to ambitious potential future options, we believe there is perhaps an even stronger case for significant evolution of the framework.

The review of RPI-X prior to RIIO-1 showed that, while the framework had delivered short-medium term productive efficiencies, longer-term focus and incentivisation was needed to drive enduring customer value. However, changes made for RIIO-2 have led to a much shorter-term focus being adopted. The now five-year price controls in reality are very short in duration in the context of what is needed to deliver net zero and, coupled with reduced incentives, have resulted in a regulatory framework that is more akin to RPI-X than the original principles of RIIO.

The first sentence in the case for change section of your letter infers a great deal of control must be exerted by Ofgem to “ensure” the delivery of what consumers “want and need”. However, we believe this perhaps needs to be re-cast to consider what the role of regulation is in incentivising companies to deliver for customers. This is an important distinction as in some cases it would imply far less control and a framework that allows investment to occur with uncertain outcomes.

In a similar way, the view that there is “a great deal of delegation of detail from regulator to each network company” is optimistic. As an example, while Ofgem, has introduced ‘re-opener’ mechanisms in price controls to amend investments as circumstances change, in practise they have reinforced the control Ofgem has on network spending through their ‘funding’ of projects. These mechanisms also have the potential to introduce significant delay in meeting net zero owing to the time and resource needed to administer them. Furthermore, it also seems strange to refer to ‘delegating’ as opposed to ‘regulating’, as Ofgem should not see themselves somehow as responsible for running the networks.

The need for greater agility to bring forward net zero investments is something Ofgem have more recently recognised in creating the Holistic Network Design for electricity. Specifically, by introducing reforms to accelerate planning, approval and connection queuing processes. With the upcoming Heat Policy decision fast approaching, what is now needed are greater levels of proactive planning for alternative potential outcomes across energy vectors and to pre-agree a framework to support change more quickly. This could build on the principles of recent advances in electricity, but will likely require different approaches in practise as changes required in gas post-decision will be far wider ranging than purely securing load growth.

RIIO-2 controls have also introduced further layers of regulatory complexity to set and administer controls. For example, frameworks such as the Network Asset Risk Measure (NARM), introduced in principle to allow networks to trade-off what interventions they undertake to deliver a risk reduction output, are now being used to micro-monitor each intervention made. Furthermore, this and other changes have led to dramatic increases in scale of in-period reporting creating increased burden and cost for Ofgem, with questionable benefit for customers.

Given the scale of upcoming strategic issues, maintaining approaches of today will place increasing pressure on Ofgem’s resources, at a time where we have observed them to be stretched as it is. As such, we believe there is a clear need to simplify the framework applied to network activities not impacted by the transition immediately.

Options for evolving the framework

Given the strategic challenges the sector will face over the coming years, and the strong case for change from the RIIO-2 framework, we agree with Ofgem that consideration of a broad range of options is needed. However, we do not believe that any one of the options put forward on its own provides the complete answer.

In designing and evaluating potential options to evolve the framework we believe a set of guiding principles should be applied. In particular, we think any option(s) adopted should support:



1. **Simplicity** – to reduce current levels of complexity and regulatory burden so that they are proportionate to benefits they deliver for customers.
2. **Fairness** – to balance the delivery of long-term value for customers and appropriate returns for investors.
3. **Whole-systems alignment** – to ensure we deliver the right mix of energy to support a sustainable net zero transition.
4. **Incentives for investment** – balancing the stability provided for investors in the current framework, with making changes to instil agility and speed for investments to come forward at pace as policy decisions are taken and uncertainties resolved.
5. **Deliverability** – so that any changes to the RIIO-2 framework can be developed and put in place in time for 2026 (or with appropriate interim measures defined).

Our view is that we will need a consistent overarching framework in principle to ensure whole-systems thinking. We are therefore supportive of better alignment of price reviews across energy vectors through consistent planning and/or by bringing timelines of their setting closer together. However, precise regimes applied in practice will likely need to differ between electricity and gas to address specific challenges. For gas we think a ‘two-part’ framework is important to explore, as different company activities are subject to different issues. Specifically, distinguishing between:

- *‘Base’ expenditure/activities* – encompassing all works and no regret expenditure involved in delivering methane gas to customers; and
- *‘Transition’ expenditure/activities* – defined as those areas relating to meeting net zero goals and, as such, dependent on the outcome of key policy and technology uncertainties over future transition pathways (such as the Heat Policy decision).

Base activities could be regulated under a modified RIIO framework which has the principles of its original intent (longer-term or continuous settlements enabling innovation, simple and clear outputs and positive incentivisation of key outcomes that customers value the most), together with significant simplification in setting and administration of the framework. This could specifically include amendments to NARM and reductions in regulatory reporting to lessen burden on Ofgem. Any concerns over imprecision, legitimacy of returns or financability constraints raised through these changes could then be managed through effective and more prominent use of appropriately calibrated Return Adjustment Mechanisms (RAMs).

Transition activities in contrast could then be assessed and approved on a more frequent basis and not pinned down to price control timelines. The key in this area, will be putting in place essential building blocks to ensure the right whole-system investment decisions are being made. To do this requires *fully* whole-system plans for electricity and gas to be defined (between the networks, local institutions, the FSO and Ofgem), clarity over which organisation(s) in different circumstances determine the needs case for investment and a revised whole-system Cost:Benefit assessment framework. However, given the FSO, who may be best placed to lead this work will not be established until 2024, interim arrangements are needed urgently to allow for a swift reaction to the Heat Policy decision in 2026.

Next steps

We are keen to support you in your next phase of engagement to develop options further. Particularly, given the short time available to implement any changes for the next price control. With this aim, we are developing our thoughts on how the two-part framework we have outlined could be operationalised.

We consent to our views being published and would be happy to discuss any points we have made in further detail.

Yours sincerely

Richard Court
Director of Regulatory Strategy

By email

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

We agree with the overarching intent of the Open Letter. To deliver the right net zero transition for customers will require a regulatory framework that can support record levels of investment in new and uncertain technologies – a paradigm different from the environment in which the current approach was devised – meaning significant change may be required.

The particular strategic issues for future price controls identified by Ofgem cover some of the key areas where we believe change may be needed – specifically to introduce greater levels of whole-systems thinking, react and manage ongoing policy and technology uncertainties and integrate changes in institutional structures (such as the in establishment of the FSO). Indeed, these reflect a number of the points we previously raised in our *Developing the Green Print for Economic Regulation: RIIO for 2050* document, published earlier this year and which we have been engaging with Ofgem, BEIS and the wider sector on over the summer.

That said, the Open Letter does not explicitly consider two key issues which we think need to be at the forefront of Ofgem's thinking when designing the next price control review process.

The major transformation of gas networks required to deliver net zero

The first of these issues is the lack of sufficient recognition of the inevitable major transformation of the gas sector required over the coming decades and the categorisation of hydrogen as “out of scope” of potential reforms.¹ The Open Letter only contains limited references to potential changes in gas demand over time without recognising that, no matter what Government's Heat Policy decision precisely is in 2026, gas networks of today will need to fundamentally change what they deliver for customers to meet net zero.

It is unlikely to be a matter of growing the network long-term, as with electricity networks, or conversely gradually de-connecting consumers over time – rather, networks will need to support swift uptake of hydrogen heating (through the re-purposing of existing networks or development of new pipelines) and/or sectioning the network off for decommissioning. It is essential that this change is proactively planned for ahead of the policy decision on heat (irrespective of the particular date it is determined) as any delay could risk:

- meeting net zero goals on time (and causing greater transitory emissions);
- consumer ability to utilise a hydrogen option (if available); and
- higher long-term transition costs to customers, should unnecessary investments be made in the interim.

Alongside this, there is no mention of how the future regulatory framework may need to evolve to support the development of new/re-purposed infrastructure to transport hydrogen for industry and power. This is particularly important to consider given Government's existing policy commitment to deliver production of 10GW of hydrogen by 2030 as part of the British Energy Security Strategy. We believe it is critical that this is also factored into Ofgem's assessment of the right structure and framework to apply to future price controls.

The need to support methane and hydrogen creates a strategic issue of regulatory burden

Whilst considering the required transformation of the gas networks to meet the Net Zero regime, it is clear that customers will still require a concurrent methane gas service for a significant time to come, meaning the vast majority of existing services and cost requirements will still be needed over upcoming price controls.

The RIIO framework was introduced partly to instil greater levels of long-term planning and decision-making in the economic regulation of energy networks to deliver value for customers over the same timeframe. For example, through the use of longer price controls in RIIO-1 to enable innovation and incentivise stretching behaviour from networks. At RIIO-2, however, the nature of the price control set became much more focussed on driving near-term efficiency gains, delivering cost and return reductions to support short-term affordability and a significant

¹ See Footnote 14 in Ofgem (2022), “*Open letter on the next price control review process*”



constraining of positive incentivisation. This has led to a much more granular and short-term framework being put in place with a significant increase in regulatory burden for all parties, both in outputs set and approaches to monitoring. The evidence to date suggests that this burden is not manageable by Ofgem alongside all of its other priorities and creates a significant cost and distraction for networks in delivering services to our customers. We therefore believe that simplification is a key strategic issue to consider in designing the framework going forward.

2. Do you have any views on the case for change we have outlined?

The central question noted within the Open Letter is “whether it continues to be practical and proportionate to follow periodic processes across the full remit of company activity when wider system challenges indicate a growing proportion of investment activity that requires decisions to be made in a faster and more coordinated manner?”.

While this is clearly an important consideration for the shape of the future regulatory framework, we believe it is unlikely to provide a ‘silver bullet’ for meeting the strategic issues identified both by Ofgem and as set out in our response to Question 1. For instance, longer review periods or shorter ones may not be sufficient to ensure we deliver long-term value for customers in meeting net zero – only sufficient focus on long-term outcomes can deliver this, which is likely to necessitate change in other areas of the framework.

Given the strategic issues that need to be considered, we think the central question of the Open Letter could be re-cast to focus on *whether the current regulatory framework is fit-for-purpose to deliver long-term value for money to customers in meeting net zero?*

Based on work we have been undertaking and engaging with you on as part of our *RIIO for 2050* initiative we have identified three key cases for change, which build on those in the Open Letter, for where the current framework may need to evolve. These are detailed below.

The framework needs to ensure greater whole-system alignment to ensure the right transition

The regulatory framework of today siloes the planning of electricity and gas networks and we agree greater whole-systems planning (including both electricity and gas) is required to ensure we deliver the right mix of energy to support a sustainable net zero transition.

Controls for electricity and gas networks are currently staggered and are not pinned down to a consistent set of whole-system planning assumptions. This means at a single point in time, it is unclear whether networks across energy vectors are making investment decisions that are consistent with developing the same net zero pathways. This results in Ofgem having to make complex judgements about how to adjust controls to ensure alignment. For example, in their ED2 price control Ofgem have recently had to adjust DNO cost allowances to ensure they deliver a consistent low/no regret future energy pathway for consumers given uncertainties in other sectors (particularly heat).

The FSO is proposed to lead the strategic planning of both electricity and gas networks to deliver net zero by 2050. In this role, one of its first priorities is to create a Holistic Network Design for the electricity sector, building on work already being undertaken by National Grid ESO. We understand the intent is then to build on this plan so there are a set of consistent pathways to net zero which consider electricity, gas and other energy vectors. Such pathways, combined with local energy plans could then form the basis for network business planning and greater alignment in future price controls.

With the FSO not set to be established until 2024 and local planning governance currently being consulted on, interim arrangements will need to be put in place to develop a consistent set of whole-system plans and given the potential different forms of the Government’s Heat Policy decision in 2026, such whole-system plans will need to consider more than one scenario. Even with consistent underlying assumptions though, it may also be appropriate to consider reducing the time between the setting of price reviews so investment decisions which impact on both sectors can be taken at a similar point in time with a consistent set of information.

The framework must allow for swift responses as uncertainties are resolved

For gas networks the next price control period is expected to be set concurrently to, or only a matter of months before Government gives strategic direction on the use of hydrogen in home heating. No matter the decision reached this will have significant impacts on what electricity and gas networks need to deliver for customers over the coming decades. It is, essential that networks can take any decision reached and implement changes to their activities quickly to instil pace in the transition and minimise long-term costs for customers.

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Under the current framework, however, this change in policy would be recognised and actioned through a re-opener. This approach is open-ended and reactive. Furthermore, given the size of potential impacts and likely timescales, Ofgem likely would need to re-open and re-run large parts of the gas price control only a matter of months since it was set. This could introduce a prolonged process to determine the right course of action – placing strain on its time and resources and introducing significant delay to meeting net zero.

The need for more proactivity in adapting price controls for uncertainty is already being looked at by Ofgem in electricity. For example, through extended use of automatic Uncertainty Mechanisms (volume drivers) as part of ED2 to amend load related expenditure and 'fast track' planning and approval processes for programmes of transmission and offshore investment needed to deliver the Electricity Networks Strategy and initial phases of National Grid ESO's, Holistic Network Design.

In contrast to electricity networks – where the outcome of the Heat Policy decision will read across to the level of network reinforcement required – for gas networks, a more extensive transformation will be needed. For example, in some areas whole networks may need to be re-purposed to inject hydrogen and/or in other places, sections of network may need to be decommissioned. This presents a very different challenge and one which will unlikely be met by applying the same methods currently being developed for electricity. This likely means a different approach in practise will be needed for gas.

The level of burden the current regime places on the regulator across all company activities

Over recent years Ofgem has needed to play a greater role in a multitude of areas to support customers. Together with networks it has had to support the response to the retail crisis, support management of the impact of large storms and now support winter preparedness given potential forthcoming energy reliability challenges. Alongside this Ofgem needs to also play a key role in the energy transition and devote time and resource to addressing the strategic issues noted in the Open Letter and in our response.

At the same time, however, Ofgem is presently managing short five-year price controls, with each taking around three years to set. The nature of these controls under the RIIO-2 framework in addition, has become increasingly complex and intensive to administer within regulatory periods. For instance, the RIIO-2 framework:

- introduced a number of more complex outputs, which Ofgem monitors at a detailed level, such as NARM – to assess outputs of asset health expenditure (see Box 1 below); and
- reserved a number of key investments to be considered through re-openers. Cadent networks by themselves having 14 of these, with each potentially taking as much as a year to administer.

Box 1 – Changes to asset health outputs, introduction of NARM

Introduced at RIIO-2 to build on the Network Output Measure (NOM) of asset health, NARM was originally intended to support the measurement of network risk reduced by GDNs. Furthermore, in setting out a fixed target to achieve it would also permit 'trading' of interventions to achieve the least cost solution for customers.

Since introduced, however, Ofgem have developed the framework at a much more detailed level and introduced complex reporting requirements so that it is able to 'mimic' and micro-monitor each investment decision made by GDNs. This has added to the level of burden on Ofgem and companies to administer the process and has fundamentally moved the framework towards 'input-based' regulation – far away from its original intention.

Furthermore, the target of risk to be removed for the period has been made dynamic. This means that the overall output to be achieved varies year to year and is difficult to predict owing to the value of particular interventions being updated at the same time. Such an approach makes it difficult for networks to assess with firm degrees of accuracy how well they are performing to reduce risk to required levels for the period.

The level of regulatory reporting and monitoring Ofgem undertakes across all company activities has also increased significantly between RIIO-1 and RIIO-2 (as shown in Figure 1). This has also included greater levels of duplication between different reports provided. For example, with a

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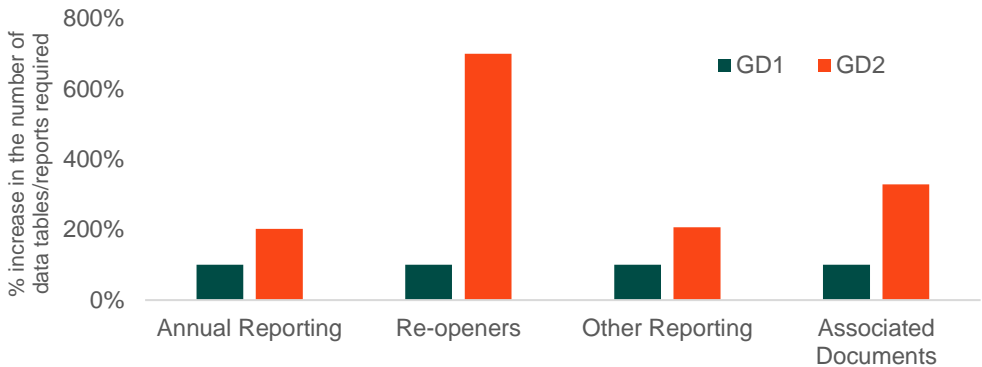
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large amount of annual environmental submission information also being contained within annual Cost and Volume Regulatory Reporting Packs.

Figure 1: Increase in regulatory reporting in RIIO-GD2, compared to RIIO-GD1



Source: Cadent analysis

While it is understandable for the regulator to want to set precise controls and seek greater levels of information to ensure networks are delivering value for customers, the need to focus on addressing strategic issues to deliver net zero, raises the question as to whether current processes are proportionate and deliver optimal long-term value for customers. We therefore welcome Ofgem’s recognition of the level of process being applied as a case for change for future price controls as we are now seeing these competing pressures placing significant strain on them. For example, most recently important work is being paused or deferred to manage workload (such as, the completion of allowances disaggregation for GDNs) and questions are being raised about how to manage the impact of assessing re-openers.

So that Ofgem is able to place its resources to deliver most benefit to customers we think it is imperative that, where possible, the setting and delivery of price controls are simplified, with greater onus put on companies to manage how they deliver outputs. This could then be met with protections for affordability and fincability provided through appropriately calibrated Return Adjustment Mechanisms, rather than granular input/output definition.

3. 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?

Given the strategic issues that will now face the energy sector until 2050 and the current state of the price control framework, we believe there is a clear case for change to consider alternatives for the next gas and electricity price controls to be put in place from 2026.

Our view is that we will need a consistent overarching framework in principle to ensure whole-systems thinking. We are therefore supportive of better alignment of price reviews across energy vectors through consistent planning and/or by bringing timelines of their setting closer together. However, across electricity and gas we also recognise that there are different challenges to be navigated, meaning precise regimes applied in practise will likely need to differ. This also extends to different company activities.

In gas, though a major transformation is certain to take place to support decarbonisation, for the next decade at least, distribution networks, such as ours, will need to keep the energy flowing by transporting methane to our customers as we are doing today. Indeed, over this period we envisage the vast majority of work we deliver will continue in a similar form as it has been and will not be materially affected by key uncertainties. Alongside this, however, there are also a number of investments/activities that will be materially affected by Heat Policy in particular, but also determinations on blending and industrial clusters, where new approaches could be needed.

At present, the RIIO-2 regime applies to all network activities in electricity and gas, and as a result, is not best placed to address identified issues necessary to support networks in delivering the energy transition over the coming decades. For instance, the complex nature of approaches applied to the setting of the price control and extensive nature of reporting burden is in place for activities that companies have been delivering in a stable way for a number of decades. This means that a disproportionate level of resource, time and effort is being exerted on areas of less strategic importance in delivering net zero. In addition, the focus on short-term affordability, use of re-openers and lack of whole-system alignment could each act as barriers to ensuring that we



deliver the transition at minimised long-term cost and on time, through being able to react quickly to uncertainties in the correct way at the whole-system level.

We therefore believe that alternatives must be considered.

To action the specific challenges that different areas of network businesses are likely to face, we believe that the current framework could be adapted into a **'two-part' regime** whereby different sets of company activities are regulated in different ways to address current identified issues specifically. In particular, gas company activities and associated expenditure could be split by:

- **'Base' expenditure/activities** – this would encompass all works and no regret expenditure involved in delivering methane gas to customers with a focus on securing: safety, resilience of supply, continual skills development and continually improving service to our customers.
- **'Transition' expenditure/activities** – defined as activities and expenditure that relate to meeting net zero goals and, as such, are dependent on the outcome of key policy and technology uncertainties over future transition pathways. For example, investments necessary to re-purpose existing pipelines or build new infrastructure to support decarbonisation of heavy industry power and heat and/or decommissioning where required.

Base activities are more predictable given they will represent a continuation of what networks have and do deliver for customers today. As such, a similar shape of regulatory framework could be applied, albeit given the certainty over what outputs need to be delivered, there is an opportunity for regulating these activities over the long-term. For instance, either via longer price controls than currently used (e.g. 10 years as was considered at the start of RIIO-1) or by setting a continuous regime that is only re-opened as and when necessary. However, to manage such a long-term regime and ensure networks continue to deliver efficiently and continually improve service for customers will need:

- A significantly simplified approach to the setting and monitoring of regulatory outputs. For example, the number of outputs set could be reduced and simplified to a core efficiency challenge and a set of key targets for networks to meet, which are set upfront. This would then permit reduced burden for the regulator in monitoring such targets through reporting processes. However, to ensure that appropriate control over affordability and fincability is retained, other counterbalances may be also required.
- Greater use of positive incentivisation. At RIIO-GD2 there was a significant reduction in the positive incentivisation of companies to deliver stretching performance for customers. Continuation of such an approach could lead to a 'compliance culture' in the industry with networks only meeting minimum standards to avoid potential penalties. We remain of the view that positive incentives are powerful tools to drive behaviour to support the best outcomes for our customers. For example, through our Collaborative Streetworks incentive, we have reduced disruption by 184 days in a single year for customers across our London and Eastern networks – with positive recognition from key stakeholders, such as the Mayor of London.

In contrast, for activities and expenditure related to the transition, what is needed a more proactive and agile approach. In particular, ones that allows for clear whole-system understanding for how electricity and gas networks could evolve towards 2050, and the ability for investment decisions to be taken more frequently and quickly once policy decisions are taken and technological uncertainties resolved.

To deliver this, we do not think a fixed price control may be the most appropriate form of regulation and we are seeing in practise the difficulties this is creating for bringing forward necessary investments. For example, for projects such a HyNet which are essential to meet Government's British Energy Security Strategy targets we are now working with Ofgem and BEIS to 'find' funding routes within the current fixed framework via re-openers or other mechanisms – introducing significant additional lead time and resource for getting critical works started.

A key enabler to establish this new type of regime is a consistent whole-system planning approach including:

- consistent and evolving underpinning assumptions for network investment planning based on whole-system energy plans for different pathways to achieve net zero (dependent on the potential outcomes of key uncertainties like Heat Policy);



- new processes for establishing the need for transition investment, assessing options put forward and approving investments across energy vectors; and
- clarity over the roles of the FSO, Ofgem, BEIS, networks and local planning bodies in the administration and governance of transition investments.

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

Based on our responses to the other questions above, we think that to ensure the regulatory framework is fit-for-purpose to deliver long-term value for money to customers in meeting net zero requires the development of tailored options to address specific issues. This should build on the principle of supporting consistency across energy vectors, but in practise taking different approaches in electricity and gas, and between company activities, where needed. The options put forward by Ofgem represent a starting point for doing so, but we do not believe that any one of the options put forward on its own provides the complete answer – with a mix of approaches likely needed.

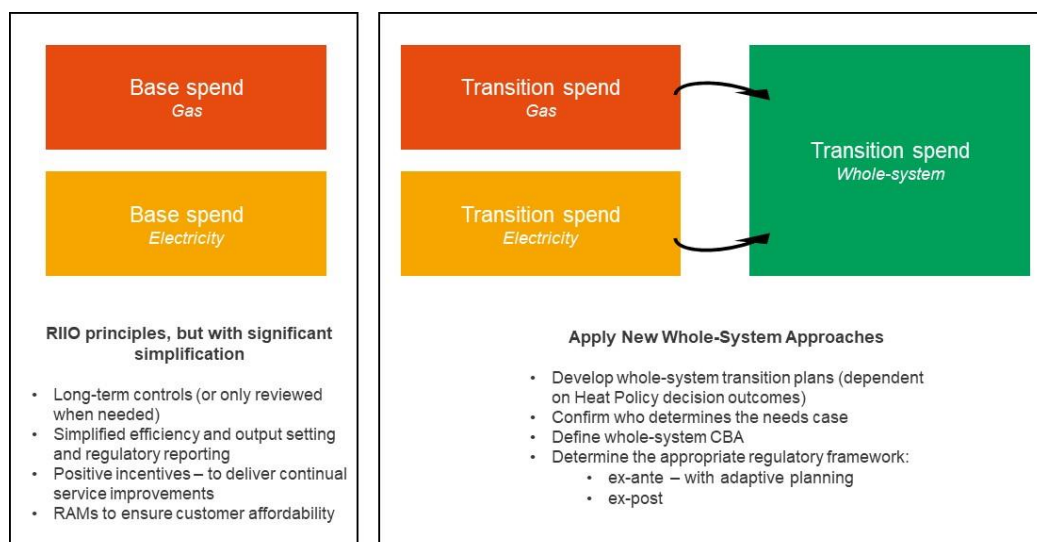
Taking a tailored approach and utilising the right mix of regulatory tools and techniques for the challenges at hand is not something new, however. Indeed, the current regulatory framework could be characterised as incorporating elements of other options put forward by Ofgem implicitly:

- The five-year length of the price control coupled with the small level of incentives in the RIIO-GD2 framework are more akin to Ofgem's 'alternative ex-ante regime' (Option 2) which is similar to the RPI-X framework, rather than RIIO as originally conceived.
- Re-opener mechanisms in the RIIO framework have an element of ex-post clawback potential similar to Ofgem's 'ex-post regime' (Option 2).
- More recent changes to the framework brought forward as part of actioning the Electricity Networks Strategy and delivering the Holistic Network Design for electricity practically involve the ESO (pre-cursor to the FSO) establishing the needs case for and agreeing rates of return of investment – which is similar in shape to Ofgem's Option 3.

A two-part approach to the future regulatory framework

In line with our response to Question 3 we believe different approaches are needed for Base and Transition expenditure as described in Figure 2 and expanded upon below (in the context of gas).

Figure 2: A potential future two-part regulatory framework



Source: Cadent analysis

The regulatory framework for Base expenditure/activities

For Base expenditure, we believe the original principles of the RIIO framework continue to be appropriate to apply. However, this does not mean simply applying the RIIO-2 framework, which today is closer to the previous RPI-X regime in several respects. Rather what is needed is:

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1. **Significant simplification** – to reduce the burden on Ofgem in setting and administering the price control whilst continuing to deliver the same benefits to customers by:
 - *Taking a long-term approach to regulation* – as the types of outputs delivered are unlikely to change materially over time, the framework could be put in place over a longer period than today, or taken forward continuously (reviewed only when necessary). This would then reduce the amount of time and resource expended by Ofgem in the setting of the control, freeing this up for more strategic goals.
 - *Simplifying the setting of costs and outputs* – the level for complexity in the regulatory framework today is likely to be disproportionate to that required to ensure networks are delivering predictable services in the right manner for customers. A particular area where this could be achieved concerns the NARM framework where we believe it should be taken back to its original intent by providing a single or small number (e.g. asset category level) of risk reduction targets to meet over a control period or specified length of time. This would then allow customers to be assured of asset health improvements they are receiving for base expenditure, whilst minimising burden and uncertainty over actual investment planning for Ofgem and networks.
 - *Reducing the level of regulatory reporting* – simplifying the framework to focus on Base activities and reducing the number and complexity of outputs will also support reductions in regulatory reporting. For example, with greater focus on targeted reports on specified outputs as opposed to a continual stream of duplicative information which Ofgem continuously needs to monitor.
 - *Ensuring control of affordability and fincability through appropriately calibrated adjustment mechanisms* – current complexity of the framework and levels for reporting have emerged over time so that Ofgem is able to ensure its control over short-term affordability, returns and fincability. However, the benefits of greater simplicity need not come at any cost of affordability, returns or fincability as Ofgem can make greater use of RAMs approaches established at RIIO-2. This would then allow any unanticipated excessive gains to be returned to customers if ever necessary and create stability for investors by ensuring base levels of returns in the face of adverse circumstances.
2. **Greater use of positive incentives to drive improved service** – to ensure that in delivering base activities networks continue to stretch themselves to improve services for customers, greater use of positive incentives should be utilised. Particular areas which could be targeted include:
 - Customer Satisfaction (C-SAT) – building on measures in place at RIIO-2
 - Security of Supply / reliability – particularly, given the greater intermittency of other energy sources the transition will introduce
 - Leakage and reductions in business environmental footprints – to continue to reduce levels of transitory emissions through to 2050

This approach could be viewed as a combination of Ofgem's options 1 and 2 as set out in the Open Letter – retaining the benefits of the RIIO framework, with greater simplification of the regime. In doing so it could reduce burden on Ofgem and reduce cost to customers, allowing for greater focus to be placed on more strategic activities to support net zero.

The regulatory framework for Transition expenditure/activities

For *Transition* expenditure, we think the objective of the regulatory regime should be to permit a swift reaction as policy and technology uncertainties are resolved and the transition pathway to net zero becomes clearer. Given this, we do not think a fixed price control period is the best approach to utilise.

There has been and will continue to be uncertainty over the timing of key decisions which impact the transition, as well as what they actually will be. As it is unlikely the setting of new price control periods will line up exactly with policy decisions, this will mean, without change, relying on the use of reactive re-opener processes which could delay the delivery of action when it is most needed (as described in our response to Question 2). As such, we believe that for Transition activities/expenditure the regime needs to evolve so that investment decisions can be taken when needed and at pace – de-coupled from arbitrary timelines.



Before considering what the appropriate model to deliver Transition activities is, however, there are more fundamental building blocks that need to be put in place.

The first of these are **whole-system network plans** to allow for consistent low/no regret investment planning and decision-making across electricity and gas. Key features of these plans should be:

- A set of agreed pathways which deliver net zero by 2050.
- An understanding of key upcoming 'trigger points' which will determine the pathway that needs to be followed based on potential policy decisions and/or resolutions of technological uncertainties (e.g. Heat Policy).
- Requirements for both gas and electricity network infrastructure to be considered in parallel.

At present, while shared transmission-distribution plans for electricity networks are being developed building on the Electricity Networks Strategy - a true Holistic Network Design for electricity and gas does not exist. The FSO once established will have an obligation to develop these type of plans, but as this will not be in place until 2024 it is unlikely they will be sufficiently well-developed to inform future regulatory arrangements for gas networks after RIIO-2 (from April 2026). Therefore, we think it is imperative that current system operators, distribution and transmission networks together with Ofgem to begin the process to develop whole-system plans in advance of the FSOs inception.

Based on these plans new investment assessment and approval processes can be put in place. We think these must contain:

1. **Clarity over which organisation(s) determines the needs case for investment.**
Today Ofgem must assess the benefits and costs of investment, but in some cases there may already be established need for investment at a national (BEIS) or local level. This can often lead to delay and uncertainty over what investments are brought forward and when.
2. **A whole-system Cost:Benefit Assessment (CBA) framework** which values the real option of bringing particular investments forward today versus delaying them and the costs this entails. Today the CBA framework is more focussed on shorter-term safety and environmental benefits delivered only.

In delivering Transition investments, both ex-ante and ex-post approaches (which could be developed as an extension of Ofgem's options 1, 3 and/or 4) could then be put in place. However, whatever the model chosen, it will be important to ensure that what is used is sufficiently agile and able to balance risk with return to incentivise investment while managing affordability. For example:

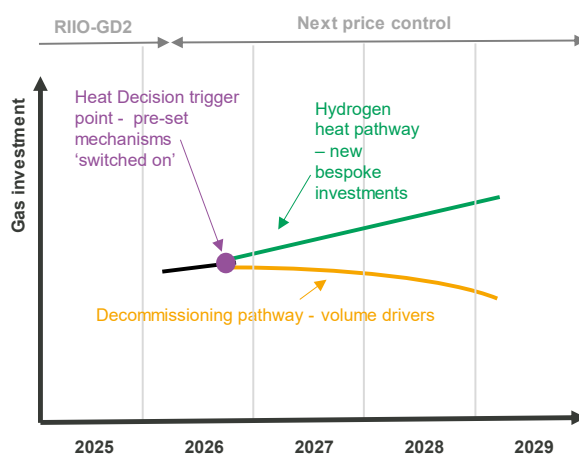
- Were an ex-ante approach similar to RIIO (Option 1) to be utilised, more proactivity will be needed to navigate uncertainties. Our view is that to deliver this the framework should seek to build on adaptive planning techniques so that the scope of investment and funding mechanism are clear upfront. Once the need for a particular investment is then established, pre-agreed funding mechanisms could be automatically put in place to avoid any delay. An example for how this could be applied to the Heat Policy decision is set out in Box 2 below.
- Were an ex-post approach to be utilised (Option 4) the outputs and potential clawback mechanisms used need to be appropriately designed such that they do not raise risk and the required return for investors significantly high. To do this it will be key for any clawback mechanisms (e.g. for the timescale of delivery, how much capacity is delivered, etc) to be agreed upfront with no potential for unexpected adjustments later on.

Box 2 – adaptive planning and the Heat Policy decision

Adaptive Planning approaches were developed in the academic literature on climate change and are now being used for future water price controls by Ofwat from PR24 onwards. Applying their principles to investments contingent on the Heat Policy decision outcome would involve Ofgem building on the current framework in three steps:

1. **Establish several alternative investment plans** configured on additional investments to support hydrogen and/or decommissioning before the decision takes place – based on overarching whole-system plans (this could involve, for example, a ‘hydrogen heat pathway’ where there is widespread adoption, a ‘decommissioning pathway’ and a combination of the two – potentially with different regional transitions)
2. **Set the Heat Policy decision as a ‘trigger point’** such that when it takes place it is clear which alternative investment plan needs to be implemented
3. **Develop appropriate pre-set adjustment mechanisms** for each plan to facilitate their implementation post decision. These could range from Volume Drivers to adjust levels of funding for reduced connections if decommissioning is needed, to approving certain investments as bespoke deliverables for networks where hydrogen for heat is needed.

This approach is shown illustratively in the diagram below:



Source: Cadent analysis

Considerations following the next round of price controls

Whilst we think a two-part approach to future gas regulation is needed to address strategic challenges associated with the net zero transition, we recognise under certain scenarios it may be appropriate to reintegrate different company activities at some future point. For example, in the longer-term once the future role for gas networks is determined the operation of hydrogen networks and/or decommissioning activities may become ‘business as usual’ for networks.

In this case adopting this approach today provides the option to move activities or categories of expenditure between the two different treatments, or combine them once more appropriate. However, this is likely to only be an issue once the pathway to net zero has been more firmly defined in a number of years.