**Call For Input - Impact of high inflation on the network price control operation – Conclusion and Next Steps**

# 1. Introduction

1.1 On 1 August 2023, we published a Call for Input on the impact of high inflation on the performance of the Cost of Debt ("CoD") mechanism. We are grateful for the extensive engagement we have had from a range of stakeholders on this issue to date.

1.2 The Call for Input considered an issue of when a licensee has fixed rate debt in its capital structure and outturn CPIH is higher (or lower) than a long run assumption (typically 2%), this typically creates out- (or under-) performance of real equity returns, all else being equal. Within this document we term this "the effect". For a detailed technical description please see the Call for Input.

1.3 We have concluded our review of the responses, copies of which are being published alongside this document. Respondents were composed of: 10 standalone Networks, Citizens Advice, Centrica, and an Energy Networks Association ("ENA") submission with a supporting paper from Frontier Economics. Confidential extracts from 2 network responses have been redacted. Within this document we will now set out a summary of responses and our next steps in respect of this issue.

# 2. Summary of responses

2.1 We have provided a summary of key themes from the responses below but individual responses vary by stakeholder.

2.2 ENA and Networks:

- A majority of respondents advocated for no policy action at this stage.
- All Network respondents were against the out or underperformance true up option.
- Most Network respondents stated that current requirements in relation to distributions were sufficient.
- Network respondents generally requested further detail on potential future price control changes ahead of providing comment on these options. UKPN provided

an initial assessment of the prospective options, stating that an Inflation Adjustment Mechanism may be the best option to address this issue.

2.3 Citizens Advice:

- Recommended that no policy action should be ruled out.
- Advocated for out or underperformance true up with an evaluation period over RIIO-2.
- Stated that changes to distribution reporting requirements and future price control design were worthy of consideration but are not sufficient by themselves.

2.4 Centrica:

- Recommended that further investigation should be undertaken and at a minimum would expect adequate enduring reporting and monitoring arrangements in respect of this issue. Centrica stated that the investigation should include the issue of the symmetry of the protections offered to both network companies and consumers if out-turn inflation materially deviates from the long-run assumption.

# 3. Next Steps

3.1 Within the Call for Input we outlined a full range of options[1] which we considered could be taken in response of this issue. Having reviewed the responses to the Call for Input, for the next stage, we intend to take three distinct options to consultation within the Sector Specific Methodology Consultation ("SSMC") for RIIO-3[2]. Please see Section 3.3 for further information on the SSMC and its role within the RIIO-3 price control determination. The options to be included within the SSMC are:

a. **Nominal allowance for fixed rate debt** - this approach would remove the effect under the notional capital structure and also align the cash allowance to the actual typical cashflow profile of fixed rate debt with potential benefits for financeability of licensees.

[1] Please see the appendix 1 for a description of option b and the Call for Input for the remaining options.

[2] RIIO - "Revenues = Incentives + Innovation + Outputs"

b. **Match indexation of the RAV to the long run assumption in proportion to the fixed rate debt notional capital structure assumption**[3] - this approach would remove the effect under the notional capital structure but not fundamentally alter the mechanism by which CoD is remunerated.

c. **Utilising the existing methodology and reviewing the long run assumption** - this proposal would not eliminate the effect, however, depending on the assumption adopted, may make the mechanism fairer for consumers particularly if this change can be demonstrated to result in an expected return for licensees from the effect closer to zero. This option would also offer greatest consistency with the existing methodology and CoD mechanism out of the three options.

3.2 At this stage we believe this selection of options best addresses the consumer interest in this matter over the wider options we outlined within the Call for Input.

3.3 We will consider these policy options as part of RIIO-3. RIIO-3 will determine the next set of price controls which we set for monopoly gas and electricity Network companies of Great Britain. The process will begin with consultation via the SSMC publication due on 13 December for the Gas Distribution, Gas Transmission and Electricity Transmission sectors ("GD&T3"). The policy options will be outlined in detail within the Allowed Return on Debt chapter of the Finance Annex. The SSMC is the document by which we consult on the detailed sector methodology that we will use to help to set the RIIO-3 price controls. We consider any policy action taken in respect of this issue within GD&T3 is likely to be mirrored in the next price control for Electricity Distribution. We believe consultation within the GD&T3 process enables these options to be considered in the round with other features of the price control and provides an appropriate timeframe and consultation framework for stakeholders to input into this issue. We also note this was the preferred approach in most of the Network company responses.

3.4 We wish to stress that we intend to consult on this subject in a comprehensive and deliberative manner recognising the sensitivity of this issue. For the avoidance of doubt, inflation protection is considered a cornerstone of our price control framework, and the policy options outlined only consider the CoD mechanism in

[3] This alternative proposal is derived from a solution set out by National Grid within its Call for Input response. We wish to highlight National Grid's preferred view, outlined within its response to the Call for Input, is that no action is required however has suggested consideration of this option if Ofgem is minded to-take action. Detail of the proposed application of this option will be included within the RIIO-3 SSMC.

relation to the effect. We wish to also emphasise we are not considering changes to overarching principle of providing inflation protection.

3.5 We currently consider it optimal to begin implementation of policy options from the start of the next price controls but recognise there is likely to be a requirement for a transition mechanism to facilitate implementation given differing starting positions for actual capital structures. We will outline transition mechanisms we are considering within the SSMC and invite stakeholder views and evidence. We intend to express a preferred methodology, including any transition mechanisms, at Sector Specific Methodology Decision ("SSMD") so that it can be included in the business plan financial model as the basis for companies to prepare their business plans. The SSMD will set out our decisions following consultation at SSMC.

3.6 In the Call for Input we stated that we were considering enhancing distribution reporting and transparency requirements to secure greater levels of compliance, public transparency and consistency. We intend to continue to consider distribution reporting requirements but as a separate review of the financial resilience requirements within RIIO-3 rather than directly linked to this issue. Options under consideration will also be detailed as part of the SSMC Finance Annex within the Financial Resilience chapter. As we previously stated in the Call for Input, we expect, at a minimum, Networks to act responsibly, transparently and in the consumer interest, and consistent with both the spirit and the letter of the financeability framework, when making annual distribution decisions and reviewing their distribution policies. In making distribution decisions, we expect companies to give appropriate weight to (and transparently report how they have done so): (i) ensuring financial resilience, particularly in the context of mitigating the impact of any period of low inflation, and (ii) ensuring sufficient equity availability for the investment required in the context of ensuring resilience, enabling greater energy security, facilitating the transition to net zero and/or delivering investments at pace to improve outcomes for customers.

3.7 We have ruled out an **Out or Underperformance true up** in respect of this matter. We reviewed the evidence in light of the criteria for evaluation and on balance we believe this option would likely result in net detriment to consumers overall. A strong perception of regulatory stability and credibility keeps the cost of capital down for consumers. It would require relatively modest changes in the cost of capital to increase the cost of delivering net zero by more than the outperformance considered here. Our position remains, as a general rule, such retrospective true ups would not be considered. In this unusual and specific case, we considered there was sufficient justification for us to weigh the evidence for such an approach.

3.8 We remain open to consider alternative plans, evidence or policy options that stakeholders may wish to discuss with us and look forward to continuing the positive engagement already undertaken to date.

# 4. Summary

4.1 We will consult within the SSMC for RIIO-3 on the following options:

- Nominal allowance for fixed rate debt
- Match indexation of the RAV to the long run assumption in proportion to the fixed rate debt notional capital structure assumption
- Utilising the existing methodology and reviewing the long run assumption

4.2 Distribution reporting will be reviewed as a separate review of the financial resilience requirements within RIIO-3.

4.3 We have ruled out an **Out or Underperformance true up** in respect of this matter.

4.4 We remain open to consider alternative plans, evidence or policy options that stakeholders may wish to discuss with us.

Yours faithfully,

Steven McMahon

Interim Director, Network Price Controls