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By email only: RegFinance@ofgem.gov.uk

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Dear Akshay

Call For Input (CFI): Impact of high inflation on the network price control operation

Thank you for the opportunity to provide our view on the impact of the recent levels of high inflation on the operation of energy network price controls and Ofgem's possible options to address this impact. This issue has arisen because of set of highly unusual conditions i.e. a global pandemic quickly followed by a European land war. However, even under these unusual circumstances, the "leverage effect" as estimated by Ofgem remains relatively small, in terms of its overall effect on customer bills (approximately £1.50 to £5.10¹ per annum relative to an average annual dual fuel bill of £1923).

In addition, The Bank of England has expressed its commitment to returning CPI inflation to levels consistent with the target set by Government, i.e. 2%, with CPI inflation forecast to be back at the target level by the end of 2024, so this impact is not forecast to persist.

We consider that any potential change to the existing regulatory framework should be carefully weighed given:

- The benefits that the existing simple and transparent regulatory arrangements have secured over a long period of operation;
- The still relatively small scale of the leverage effect when this is placed in context, e.g. in terms of bill impact; and
- The unusual circumstances that have led to the recent episode of high inflation and the present policy concern as expressed by Ofgem, which are unlikely to be repeated.

Based on the points above we believe that there is a strong rationale for not changing the existing price control framework.

A key concern for UK Power Networks is the reopening of either the RIIO-ED1 and/or RIIO-ED2 price controls. We believe that this option would not be in customers' interests. As the Frontier report highlights, retrospective reopening of a previous price control will damage investor confidence in the regulatory regime because:

- As an investor, you will now know that there is a risk your returns will be censored going forward if they are deemed "too high." This will inevitably increase the perception and reality of regulatory and political risk and will increase the cost of capital.

¹ Call for Input – Impact of high inflation on the network price control operation, Ofgem, page 5, July 2023

- It will also weaken the confidence of investors in the wider commercial framework. Going forward, a company would now have to factor into all of its future decisions the risk that if some improvement they make turns out to be “too good,” then the rewards of that may also be confiscated, whether in part or in full. Management teams would now have to “risk adjust” their business cases and this will inevitably limit their appetite for such investment and limit the speed with which innovations are identified, pursued and rolled out.

We would also highlight that the Competition and Markets Authority (*Phoenix Gas CMA 2012 and Ofgem (RIIO-ED1 mid period review)*) both ruled out retrospective adjustments precisely because it undermines the stability and transparency of the regulatory regime and would result in higher costs for customers in the long term. Furthermore, voluntary contributions are de-facto retrospective adjustments and would suffer from the same issues.

We believe that if it can be demonstrated that it is in customers’ interests to change the specific price control treatment of inflation under these extreme events, then it should be carefully considered as part of the current RIIO-3 price control framework development. This would allow Ofgem to appropriately consider how any change, if it was determined to be necessary, would interact with the other elements of the price control framework. This is essential to ensure that there are no unintended consequences which could be detrimental to customers’ interests overall or damage investor confidence in the sector at a time of increasing investment needs. It would also enable licencees and stakeholders to consider whether the overall price control package is acceptable.

In this CFI, Ofgem did not set out a detailed description of the mechanics of the four forward-looking policy options to address the impact of high inflation that it has identified. To provide constructive feedback to Ofgem, we have had to make assumptions of what the different options could entail and have provided an initial qualitative high-level analysis summarised in the table below. We have assessed these options based on four specific criteria:

1. **Effectiveness** – does the proposed option address the impact of unusual inflation events?
2. **Impact on financial resilience** – does the proposed option expose network companies to a higher risk of cashflow volatility and hence financial resilience issues?
3. **Impact on customer bills** – does the proposed option increase customers’ bills?
4. **Continuity in the fundamental regulatory model** – does the proposed option fundamentally alter key regulatory principles?

Option	Effectiveness	Impact on Financial resilience	Impact on customer bills	Continuity in the fundamental regulatory model
Forecast short run inflation with end of period true up	●	●	●	●
Nominal fixed rate debt	●	●	●	●
Deflating by another long run assumption	●	●	●	●
Inflation adjustment mechanism	●	●	●	●

Our initial view is that an inflation adjustment mechanism, appropriately constructed and calibrated, may be the best option to address this issue, should it be determined that the issue warrants a change to the regulatory framework in RIIO-3. A fuller explanation of our scoring is contained in our detailed response. The mechanism would in principle be similar to the existing RIIO-2 operational returns adjustment mechanism in that it:

- Only operates once pre-determined thresholds are exceeded;
- Is symmetrical;
- Is trued up at the end of price control period, minimising in period impacts on credit metrics and hence financial resilience; and
- Does not alter the fundamental underlying mechanics of the successful existing price control framework e.g. RAV indexation.

It is important that this mechanism is separate to the current operational RAM to preserve the latter's incentive properties and only addresses inflation impacts i.e. the incentive to issue debt efficiently is maintained. The development of any mechanism, if required, will be a key element of the RIIO-3 price control framework and we will work with Ofgem on its development.

We agree that it is important for dividend payments, above the allowed level of distributions or significantly above the level of dividends paid prior to the recent high inflationary period, to be justified and that dividends should not be made if it would reasonably be expected to cause the licensee material financeability issues in the future. We already have a rating agency commitment that we will maintain our credit rating at a minimum of Baa1/BBB+, two levels above the minimum investment credit rating threshold, and we are currently rated A3/A- by Moody's and Standard and Poor's respectively. Our current intention, and given realistic economic assumptions, is that UK Power Networks will continue to pay a level of dividends comparable to that paid over the last few years while maintaining our existing rating agency commitment of Baa1/BBB+.

However, it should be noted that the regulatory framework is complex with the timing of cash flows often misaligned with the timing of the performance/circumstances that drive those cash flows. Investors prefer a stable profile of dividend payments and hence companies will seek to smooth the profile of payments to achieve this. Caution must therefore be exercised when looking at a single year's payments as there will not be a perfect match between outperformance delivery and the profile of dividend payments.

We understand that Ofgem is concerned with the consistency of interpretation of the RIIO-2 reporting requirements associated with dividend payments across the Gas Distribution and Transmission sectors. We note that Ofgem will be undertaking a review of the Gas Distribution and Transmission 2022/23 Regulatory Financial Performance Report dividend information. We would welcome Ofgem sharing its findings with the sector and based on that, we would be happy to work with Ofgem to better understand what additional clarification it requires.

We trust that the above points will allay any concerns that Ofgem may have on the payment of excessive dividends and the consequential impact on financial resilience, during a period of increased investment as the UK economy transitions to Net Zero. We remain committed to work constructively with Ofgem to ensure that the UK regulatory regime continues to adapt in RIIO-3 and beyond to maintain its leading position internationally.

Yours sincerely



Basil Scarsella
Chief Executive Officer
UK Power Networks