

Energy Networks **Association response**

Ofgem Call For Input -
Impact of high inflation on
the network price control
operation

September 2023

Table of Contents

Energy Networks Association.....	3
About ENA.....	3
Executive summary	4
Our response.....	6
The complex matters considered in the Call For Input are central to the design of the current price control frameworks. Care must be taken in the characterisation of the issue to avoid over-simplification or mis-characterisation.	6
It was always expected that there might be some difference between ex ante assumptions and actual inflation	6
It is not clear that Ofgem would intervene had the difference had been in the opposite direction	6
We generally agree with Ofgem’s approach to estimating the quantum of the effect, and that the impact on customer bills is small	7
Ofgem’s review must be undertaken in a manner that is cognisant of the central role that inflation indexation has in the design of current price controls and the risks associated with changes to a long-established framework	7
No changes should be made to the current or historical price controls. Any such action would undermine investor confidence in regulatory stability and would not be in customers’ interests.....	8
Any retrospective action would be damaging to investor confidence and would cost customers money	8
Any unexpected in-period changes to the price control framework, even on a forward-looking basis, would also undermine confidence in regulatory stability and predictability and drive cost increases for customers	10
Potential changes to future price controls must be carefully considered in detail and in the context of the wider price control package. If Ofgem cannot be certain that the impact of any change will improve the design of the price control, the change must not be made.....	12
Real cost of debt allowances and inflation indexation are fundamental components of the regulatory framework. Any change to future price controls must only be considered in the context of the design of the wider future price control package.....	12
Ofgem already has a comprehensive suite of obligations and mechanisms in place regarding dividends and their reporting. Networks take those obligations very seriously	12
The current, complex price control mechanisms were developed following extensive consideration of both the individual mechanisms and the wider price control framework. Further work is required to establish whether any changes could be made for future price controls that would improve on the current arrangements. We will continue to work with Ofgem to support this work	13
Any changes to the future price control framework must be robustly tested to ensure that they do not create un-intended consequences that have adverse effects for customers.....	14
Networks will continue to work with Ofgem to assess the appropriateness of any possible changes to the framework for the next price controls	14
Appendix 1 - Overview of relevant current obligations	16

Energy Networks Association

About ENA

Energy Networks Association (ENA) represents the companies that operate and maintain the gas and electricity grid network in the UK and Ireland. Serving over 30 million homes and businesses in every part of the country, they are responsible for the transmission and distribution network of 'wires and pipes' that keep our lights on, our homes warm and our businesses running.

Our members include every major electricity and gas network operator in the UK and Ireland, independent operators, National Grid ESO which operates the electricity system in Great Britain and National Gas which operates the gas system in Great Britain.

This response to Ofgem's Call For Input is submitted on behalf of ENA's GB electricity and gas network members. Some members will explore the options proposed by Ofgem in more detail in their individual responses.

Executive summary

Ofgem's Call For Input explores components of the price control that have been fundamental cornerstones of the regulatory framework since privatisation: real cost of debt allowances and indexation of the Regulatory Asset Value (RAV) by inflation. The setting of a real cost of capital, combined with indexation of the RAV by inflation, means that network revenues and costs to customers do not vary in real terms with inflation.

Equity investors in networks have been exposed to the difference between ex ante assumptions and actual inflation for decades. Mechanisms that expose networks to variation against ex ante assumptions are found across multiple aspects of the RIIO framework and almost all other monopoly regulation frameworks. The leverage effect represents a transfer of value between the equity holders and the nominal debt holders when inflation is different from expectation; the real cost of capital remains unchanged. It is wrong to characterise the recent variations as being inconsistent with policy intent.

While it is the case that recent inflation has been higher than was anticipated when price controls were set, the customer bill impact of this difference as a result of the leverage effect is small in nominal terms.

For the majority of RIIO-1, networks experienced lower effective returns to equity holders as a result of lower than expected outturn inflation. However, Ofgem did not consider making changes when the inflation experience had been against equity.

The outcome of this review must be cognisant of the central role that inflation indexation has in the design of price controls, the significant cost to customers that would arise if any retrospective action were to be considered, and the risks associated with changes to a long-established framework.

No changes should be made to the current or historical price controls. Any such action would be contrary to regulatory best practice, would undermine investor confidence in regulatory stability and predictability, and would not be in customers' interests.

Networks need to secure very significant additional investment to meet the government's net zero and energy security targets. The consistency and integrity of the regulatory regime helps ensure our sector remains attractive to investment, particularly in the face of increasing international competition. Any retrospective action would unsettle markets to the detriment of customers.

It is established regulatory practice for changes to the regulatory framework to be well signalled in advance, thoroughly consulted on, and only applied going forwards. Ofgem has previously acknowledged this. Investors and rating agencies have commented on the adverse effects that will arise if Ofgem opts to pursue retrospective action and do not expect that Ofgem will ultimately take any steps to retrospectively claw back allowances.

If Ofgem were to act to retrospectively claw back part of the historical RAV indexation, it will send a powerful signal to investors that any apparently agreed elements of the regulatory framework should be seen as conditional on Ofgem's ad hoc judgement and discretion and could be retrospectively revisited by Ofgem in the future. Investors and management teams will inevitably assume that the same logic could apply anywhere, and all future decisions will be taken on that risk-adjusted basis. The inevitable consequences of such action would be:

- increases to the cost of capital;
- reductions to the benefits that flow to customers from investments, incentive performance and innovation delivery; and
- a reduction in the attractiveness of GB infrastructure relative to other investment options.

These would be hugely costly to customers and must be avoided by formally dismissing the potential for retrospective action.

It would be equally inappropriate to expect that investors who have borne the risk of the difference between ex ante assumptions and actual inflation for decades – including through periods where actual inflation fell short of the assumptions baked into price control parameters – should voluntarily return the difference to customers when actual inflation exceeds those assumptions. The expectation of voluntary contributions is akin to retrospective action and would have the same detrimental impact on investor confidence and customer interests.

It should be noted that we are not aware of Ofgem having set out, prior to its Call For Input, any “*key policy objective of keeping real equity returns stable relative to inflation over time*”.

Potential changes to future price controls must be carefully considered in detail and in the context of the wider price control package. The current, complex price control mechanisms were developed following extensive consideration of both the individual mechanisms and the wider price control framework. Considerable work is required to establish whether any changes could be made for future price controls that would improve on the current arrangements.

Ofgem already has a comprehensive suite of obligations and mechanisms in place regarding dividends and their reporting. Companies take those obligations very seriously. Ofgem can investigate and, if appropriate, take action if it believes those obligations are not being met.

Any changes to future price control framework must be robustly tested to ensure that they do not create unintended consequences that have adverse effects for customers. This must consider how any consequential changes to other aspects of the price control framework would be managed. For example, several of the proposed options would seem to have significant implications for other hugely important aspects of the framework such as financeability assessment, allowances for index-linked debt, the basis of the cost of capital, customer bill profiles, the operation of incentives and investment appraisal. A programme of work is required to explore possible options in much more detail. We will continue to work with Ofgem to support this work as part of the process to establish the framework for the next network price controls.

This response is supplemented by a report by Frontier Economics: “Comment on Ofgem’s Call For Input on the effect of high inflation”.

Our response

The complex matters considered in the Call For Input are central to the design of the current price control frameworks. Care must be taken in the characterisation of the issue to avoid over-simplification or mis-characterisation.

It was always expected that there might be some difference between ex ante assumptions and actual inflation

We note that recent inflation has deviated from the long run assumption that was used to set price controls. However, we are not aware of Ofgem having set out, prior to its Call For Input, any “key policy objective of keeping real equity returns stable relative to inflation over time”¹. It is therefore wrong to characterise the recent variations as being inconsistent with policy intent.

Ofgem understood that networks faced inflation risks with the cost of debt index when it stated:

“The approach used to calculate the cost of debt index implicitly assumes that all network debt is index-linked. In reality, only a small proportion of the networks’ debt is index linked and the networks are exposed to inflation risk on the rest of their debt profile.”²

Exposures of this kind to variation around price control expectations are found across multiple aspects of the RIIO framework and almost all other monopoly regulation frameworks. The energy networks have been exposed to this leverage effect for decades. It represents a transfer of value between the equity holders and the nominal debt holders when inflation is different from expectation; the real cost of capital remains unchanged. The setting of a real cost of capital, combined with indexation of the RAV by inflation, means that network revenues and costs to customers do not vary in real terms with inflation. As further explained by Frontier Economics, the leverage effect should therefore not be considered a value transfer between the company and the customer.³

There has always been some difference seen between the forward-looking assumptions used to set the price control and actual inflation. It is inappropriate to suggest that investors who have borne the risk of the difference between ex ante assumptions and actual inflation for decades – including through periods where actual inflation fell short of the assumptions baked into price control parameters – should voluntarily return the difference to customers when actual inflation exceeds those assumptions. The expectation of voluntary contributions is akin to retrospective action and would have the same detrimental impact on investor confidence and customer interests as detailed below.

It is not clear that Ofgem would intervene had the difference had been in the opposite direction

Ofgem asserts that:

“A similar symmetrical shock below the long run assumption may have compelled Ofgem to intervene”⁴

It is not clear that Ofgem would have been compelled to intervene if the difference had operated in the opposite direction because the long period of time over which the difference would affect cash flows would mean that there would be no pressing near-term problem with financial ratios requiring intervention. Ofgem’s own modelling of the impact shows that the cumulative loss due to past leverage effects on the gas distribution and

¹ As asserted in Ofgem, Call For Input - Impact of high inflation on the network price control operation, August 2023, page 1.

² Ofgem, Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Financial issues, 31 March 2011, paragraph 3.55. Note that at the time that this document was published Ofgem assumed that none of the notional company’s debt was index-linked.

³ Frontier Economics, Comment on Ofgem’s Call For Input on the effect of high inflation, 25 September 2023, section 3.1.1.

⁴ Ofgem, Call For Input - Impact of high inflation on the network price control operation, August 2023, page 5.

transmission sectors throughout RIIO-1 was similar in size to the current gain, yet no intervention was contemplated by Ofgem at RIIO-T2/GD2 to address the issue.

We generally agree with Ofgem's approach to estimating the quantum of the effect, and that the impact on customer bills is small

While we generally agree with Ofgem's approach to estimating the quantum of the issue, we note that Ofgem's analysis relies on some key assumptions and ignores some other aspects of the price control where networks' revenues have been lower than expectations. Frontier Economics explores Ofgem's modelling assumptions in more detail in its report.⁵

As Ofgem acknowledges, the quantification of the issue is highly sensitive to a number of assumptions including the length of the evaluation period and the extent to which the recent inflation trend does or does not reverse in future years. The future track of inflation remains uncertain; a wide range of forecasts exist. The full impact of the issue is therefore not yet known and will not be known for some time. However, regardless of the modelling assumptions chosen, Ofgem's estimation of the impact of the issue on domestic customer bills is between £1.50 and £5.10 per year on a dual fuel bill.⁶ The impact is also small in the context of the size of network RAVs and the scale of future investment needed.

We also note that Ofgem's analysis estimates the effect on a notional company basis. Networks' actual financing structures will often differ from those notional assumptions, meaning that the actual effect on performance will vary. For example, if networks have financed themselves with a larger proportion of index-linked debt than assumed under the notional structure, Ofgem's analysis will have over-estimated the leverage effect.

Ofgem's analysis does not recognise other aspects of the price control where networks' revenues have been lower than were assumed as a consequence of economic factors being misaligned to expectations used to set the price control. In particular, Ofgem's modelling fails to take account of the fact that the difference between CPI and CPIH has also deviated from the assumptions implicit in cost of debt allowance calculations. Companies have therefore under-performed against notional allowances for index linked debt. If this basis risk was included in Ofgem's modelling, it would have led to a lower overall quantum of estimated benefit.

Ofgem's review must be undertaken in a manner that is cognisant of the central role that inflation indexation has in the design of current price controls and the risks associated with changes to a long-established framework

Given the high level of inflation that customers and businesses are experiencing, it is appropriate for Ofgem to look at this issue. However, that review needs to be undertaken in a manner that is cognisant of the central role that inflation indexation has in the design of current price controls and the risks associated with changes to a long-established price control framework.⁷

Networks need to secure very significant additional investment to meet the government's net zero and energy security targets. The consistency and integrity of the regulatory regime helps ensure our sector remains attractive to investment, particularly in the face of increasing international competition. Any retrospective action would unsettle markets to the detriment of customers.

⁵ Frontier Economics, Comment on Ofgem's Call For Input on the effect of high inflation, 25 September 2023, Annex B.

⁶ Ofgem, Call For Input – Impact of high inflation on the network price control operation, August 2023, page 5.

⁷ For further details of the long-established framework see Frontier Economics, Comment on Ofgem's Call For Input on the effect of high inflation, 25 September 2023, section 3.1.

No changes should be made to the current or historical price controls. Any such action would undermine investor confidence in regulatory stability and would not be in customers' interests.

Any retrospective action would be damaging to investor confidence and would cost customers money

The Call For Input explores components of the price control that have been fundamental cornerstones of the regulatory framework since privatisation (real cost of debt allowances and indexation of the RAV by inflation).

It is established regulatory practice for changes to the regulatory framework to be well signalled in advance, thoroughly consulted on and only applied going forwards. Any retrospective action would be contrary to regulatory best practice, would undermine investor confidence in regulatory stability, would have significant adverse effects and would not be in customers' interests.

ANY RETROSPECTIVE ACTION WOULD BE CONTRARY TO REGULATORY BEST PRACTICE AND WOULD UNDERMINE CONFIDENCE IN REGULATORY STABILITY

The following key principles in respect of regulatory predictability were set out by the Department of Business, Innovation & Skills (BIS) in 2011:⁸

"the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence.

the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets."

Importantly, when considering the Phoenix Natural Gas Limited (PNGL) appeal regarding a retrospective change to an ongoing price control, the Competition Commission (CC) took the view that the proposed retrospective changes were not in line with normal regulatory practice:

*"In line with normal regulatory practice, our view is that any revision of previous regulatory determinations should be: well reasoned, properly signalled, subject to fair and effective consultation, clear and understood, and, normally, forward-looking."*⁹ (emphasis added)

Further, the CC considered the impact of retrospective changes on regulatory stability and the damaging effect it could have on investor confidence in the regulatory framework.

Ofgem has previously acknowledged the importance of avoiding retrospective action. For example, one of its "guiding principles" for its RPI-X@20 review of price controls was:

"No retrospective action: *We understand the importance of maintaining regulatory certainty and therefore are keen to make clear that RPI-X@20 will be focussed upon the framework for future regulation of energy networks."*¹⁰

Similarly, in its "Handbook for implementing the RIIO model", Ofgem set out that:

"Network company decisions will be influenced by their perceptions of the credibility of the regulatory framework. The RIIO model is designed to provide certainty and transparency about how the framework will work in the future. As part of this, we will seek to avoid any

⁸ Department for Business Innovation and Skills, Principles for Economic Regulation, April 2011, page 5.

⁹ Competition Commission, Phoenix Natural Gas Limited price determination, 29 November 2012, para 32.

¹⁰ Ofgem, Regulating energy networks for the future: RPI-X@20 Principles, Process and Issues, 27 February 2009, para 2.8.

retrospective/ex post adjustments to the package agreed in final proposals and licence modifications as this could undermine regulatory commitment.”¹¹ (emphasis added)

Other sector regulators have followed the same principle that changes to the regulatory framework must only be made on a forward-looking basis. For example, in 2005, Ofcom changed the way it valued BT’s copper access network assets. The change meant that BT was allowed to recover more than its costs for the network assets that were deployed prior to August 1997 (when the accounting change came into force). However, Ofcom chose not to claw back any of the associated over recovery from BT, on the basis that this could set a precedent of ex post appropriation that could, in turn, affect investment incentives, saying:

"Ofcom remains of the view that it would be inappropriate to propose to ‘clawback’ any over-recovery that may have crystallised in the period up to the implementation of the results of this review. Ofcom believes that any attempt to do so would be retrospective, in contravention of Ofcom’s regulatory principles, and could be perceived as opportunistic. Further, such retrospective action would set a precedent leading to investment uncertainty signalling the potential for ex-post expropriation of returns legitimately earned under the agreed regulatory framework.”¹²

THE ADVERSE EFFECT OF ANY RETROSPECTIVE ACTION WOULD BE SIGNIFICANT

Ofgem acknowledges the risks associated with making changes to price controls and that possible policy action “may raise the cost of capital to consumers to the extent it offsets the likely benefits of such an action”.¹³ The effect on the cost of capital of making retrospective changes to price controls would be significant.

However, the adverse effect of unexpectedly re-opening a price control extends significantly beyond the cost of capital. The damage to investor confidence will adversely affect service levels, investment, innovation, and efficiency in the short, medium and long term. If Ofgem signals, through retrospective action in this matter, that price controls may be re-opened if returns are different to ex ante expectations, investors and management teams will inevitably assume that the same logic could apply anywhere, and all future decisions will be taken on that risk adjusted basis. As a consequence, any retrospective adjustments will result in reductions to the future benefits that flow to customers from investments, incentive performance and innovation delivery.

Given the long-held consistency of approach across different sector regulators in this regard, any decision by Ofgem to take retrospective action would be expected to have ramifications that extend beyond energy. Such action would call into question the stability and consistency of the GB regulatory regime more generally. This would inevitably reduce the attractiveness of regime relative to other jurisdictions and reduce networks’ ability to compete for capital.

The inevitable consequences of retrospective action would be:

- increases to the cost of capital;
- reductions to the benefits that flow to customers from investments, incentive performance and innovation delivery; and
- a reduction in the attractiveness of GB infrastructure relative to other investment options.

These would be hugely costly to customers and must be avoided by formally dismissing the potential for retrospective action.

Frontier Economics explores the highly damaging effects for customers in its report.¹⁴

¹¹ Ofgem, Handbook for implementing the RIIO model, 4 October 2010, page 29.

¹² Ofcom, Valuing copper access, 18 August 2005, para 4.6.

¹³ Ofgem, Call For Input – Impact of high inflation on the network price control operation, August 2023, page 6.

¹⁴ Frontier Economics, Comment on Ofgem’s Call For Input on the effect of high inflation, 25 September 2023, section 2.2.

BECAUSE OF THE SIGNIFICANT DETRIMENTAL EFFECT, INVESTORS AND RATING AGENCIES DO NOT EXPECT OFGEM TO TAKE ANY RETROSPECTIVE ACTION

Numerous analysts and rating agencies have commented on the adverse effects that will arise if Ofgem opts to pursue retrospective action, and on their expectation that the probability of Ofgem pursuing retrospective action is low, for example:

*"We believe that it is unlikely for Ofgem to implement Option 4 The process will require a lengthy consultation and implementation period and carry significant legal risk. Ofgem's language is fairly soft and the scale of the benefit to consumers from option 4 is uncertain. It also creates significant costs for consumers by undermining the stability and predictability of the regulatory framework if investors perceive elevated regulatory risk."*¹⁵

*"While it is too early to say what policy option (or mix of options) Ofgem will go with, we are reassured that the tone of this morning's consultations signals no radical change to the principle of inflation protection, which underpins the current regulatory framework"*¹⁶

*"Given the scale of the investment challenge in electricity networks, our view is that regulatory stability is imperative, and that retroactive changes have the potential to be detrimental."*¹⁷

*"The high hurdle placed on making fundamental changes to the principles of the well-established regulatory framework in Great Britain supports our favourable view of the regime's stability and predictability."*¹⁸

*"We believe the most radical option, for example by clawing back retrospective outperformance in RIIO-2, was included largely for completeness. Such a change would undermine investor confidence in the predictability and stability of the regulatory regime when significant investment is required, especially by the electricity networks, to facilitate decarbonisation objectives."*¹⁹

In short, investors and rating agencies do not expect that Ofgem will ultimately take any steps to retrospectively claw back allowances and are clear that any such move would be detrimental. The fact that Ofgem has not ruled out retrospective change could already have created some disturbance to investor confidence.

Overall, any decision by Ofgem to pursue retrospective claw back would undermine investor confidence in regulatory stability and would not be in customers' interests. This must be avoided by formally dismissing the potential for retrospective action.

Any unexpected in-period changes to the price control framework, even on a forward-looking basis, would also undermine confidence in regulatory stability and predictability and drive cost increases for customers

Any unexpected re-opening of the existing price controls, even if only on a forward-looking basis, would also be very damaging to investor confidence and increase costs for customers. Where Ofgem expects to make changes to the framework during the course of a price control period it incorporates details of the process or mechanism via which the framework will be modified on the face of relevant licences.

We note that an intervention even in respect of these future RIIO-2 years would be retrospective in nature because it has been insufficiently signalled. In the case of RIIO-GD2 and RIIO-T2, no change was signalled at

¹⁵ Bernstein, UK Utilities: Our thoughts on Ofgem's call for input on inflation adjustments on debt, 2 August 2023.

¹⁶ JP Morgan reaction to Ofgem's Call For Input.

¹⁷ Investec, Ofgem looking at high inflation, 1 August 2023.

¹⁸ Moody's, Ofgem outlines possible changes following high inflation, 3 August 2023, page 1.

¹⁹ Moody's, Ofgem outlines possible changes following high inflation, 3 August 2023, page 4.

all. In the case of RIIO-ED2, where Ofgem signalled a potential concern regarding inflation and its intention to consult further, no meaningful description was provided of what form that change might take.

Ofgem clearly recognises the negative effect of any unexpected changes to price controls. For example, during RIIO-1, Ofgem elected not to re-open the price control during its mid-period review (MPR) noting that:

“Changes to the key financial parameters (eg cost of capital) or to clawback outperformance are out of scope and we consider that any such changes could be harmful to consumers’ long-term interests.

If we initiate an MPR for RIIO-T1 or GD1 and make changes to outputs, we are committed to not making retrospective adjustments, eg allowances related to previous years of the price control. We will also not make any changes to the cost of capital or change the totex (total expenditure) sharing factor.

As stated above, we think such issues are out of scope as they could potentially undermine the regulatory stability associated with an eight year price control and make companies less likely to commit to long term strategies that benefit consumers. Such changes could also increase the cost of finance from investors as they could perceive this as creating additional regulatory risk. We are therefore conscious of the need to balance the reduction of costs to consumers in the short term with the introduction of regulatory risk and uncertainty, which could ultimately lead to higher costs for consumers. When deciding which, if any, issues to take forward, we will be mindful of the potential risks and downsides of any changes being considered.”²⁰

“We have rejected an approach that would have provided for a wider extension of the scope of the MPR (Option 3). This is because we are concerned that this could undermine regulatory confidence and weaken incentives on DNOs to perform efficiently. This could result in increased costs, offsetting any short-term benefits, which would ultimately be borne by consumers.”²¹

Any consideration of changes to regulatory arrangements must be limited to future price controls and in the context of the wider price control package.

²⁰ Ofgem, Consultation on a potential RIIO-T1 and GD1 mid-period review, 20 November 2015, paras 1.23 – 1.25.

²¹ Ofgem, Decision on a Mid-Period Review for RIIO-ED1, 30 April 2018, page 5.

Potential changes to future price controls must be carefully considered in detail and in the context of the wider price control package. If Ofgem cannot be certain that the impact of any change will improve the design of the price control, the change must not be made.

Real cost of debt allowances and inflation indexation are fundamental components of the regulatory framework. Any change to future price controls must only be considered in the context of the design of the wider future price control package

The Call For Input explores components of the price control that have been fundamental cornerstones of the regulatory framework since privatisation (real cost of debt and indexation of the RAV by inflation). They are key components of the wider price control financing package, which in turn interact with many other aspects of the price control, including delivery of investment, innovation and efficiency.

Frontier Economics explains the components and track record of the existing arrangements in its report.²²

Ofgem's Call For Input seeks views on possible changes to future price controls in these areas, without acknowledging the potential need to make consequential design changes to other aspects of future price controls in order to maintain an appropriate and internally consistent price control package. It is not appropriate to consider such fundamental changes to key aspects of the future price control without also considering the other components of the price control that are designed to co-exist with them. The future price controls must operate correctly both as individual policy decisions and as an appropriately calibrated price control package.

The "calibration" of price control frameworks includes consideration of a wide range of components including the required level of investment to be delivered, the incentive framework, as well as the financing and financeability packages. Different sectors face different challenges and the design of the associated frameworks will need to consider how best to continue to meet those customers' needs.

We recognise that the next price controls are fast approaching, and that Ofgem has already commenced its thinking through its Future Systems and Network Regulation (FSNR) process. Any change to the future sectoral price control frameworks should be considered via those processes.

Ofgem already has a comprehensive suite of obligations and mechanisms in place regarding dividends and their reporting. Networks take those obligations very seriously

THE DISTRIBUTION OF DIVIDENDS IS A FUNDAMENTAL COMPONENT OF THE REGULATORY FRAMEWORK. IT IS IMPORTANT FOR BOTH CUSTOMERS AND INVESTORS THAT SUCH PROCESSES OPERATE APPROPRIATELY

Customers, stakeholders and investors must be confident that distributions to shareholders are appropriate. This includes being confident that dividends will not be distributed in inappropriate circumstances, for example that dividends will not be made if it would reasonably be expected to cause the licensee material financeability issues in the future.

Networks take their regulatory and fiduciary etc duties very seriously, including dividend decisions.

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. Dividend decision-making processes are therefore also complex.

²² Frontier Economics, Comment on Ofgem's Call For Input on the effect of high inflation, 25 September 2023, section 3.1.

The distribution of dividends to shareholders is a fundamental component of investor expectations. Ofgem's dividend policy relies on the nominal cost of capital being achieved by the combination of a real weighted average cost of capital (WACC) and inflated RAV. Any suggestion that this core tenet of the price control could be changed must be treated very cautiously as it goes to the heart of investors' legitimate expectations when they invest in networks, and comes at a time when networks are expected to raise new capital required to support the transition to net zero and energy independence.

OFGEM'S CURRENT ARRANGEMENTS AND OBLIGATIONS ON NETWORKS REGARDING DIVIDENDS AND REPORTING ARE COMPREHENSIVE

Ofgem already has in place a very comprehensive set of obligations and mechanisms to manage financing, financial resilience and dividend distribution. These include board level obligations and key roles for companies' auditors. The current arrangements include financial resilience reporting requirements that impose additional requirements on any companies that fail to meet certain resilience criteria.

Companies take those obligations very seriously, and Ofgem can investigate and, if appropriate, take action if it believes those obligations are not being met.

Further details of the comprehensive obligations that are currently in place are provided in Appendix 1 to this response.

We recognise that it can sometimes be difficult for customers and stakeholders to fully understand the decision-making rationale behind dividend distributions or see the link between companies' performance and the level of dividends distributed. The complexity of the regulatory framework, including the misalignment between cash flows and performance, combined with companies' decisions regarding the level and timing of dividends in light of financing needs, makes dividend decisions more difficult for customers and stakeholders to understand than is the case for some other industries.

Ofgem's requirements for reporting of dividend policy and dividends distributed are extensive. In particular, the Regulatory Financial Performance Reporting requirements were introduced to collect accurate and consistent information from networks to help customers and stakeholders to understand networks' performance on a comparable basis.

We recognise that companies may have historically interpreted those various requirements, and in particular reporting requirements, in slightly different ways and have sometimes presented information in differing formats. We would be happy to work with Ofgem to explore where further clarification of the requirements would be beneficial.

The current, complex price control mechanisms were developed following extensive consideration of both the individual mechanisms and the wider price control framework. Further work is required to establish whether any changes could be made for future price controls that would improve on the current arrangements. We will continue to work with Ofgem to support this work

Very little detail is included in the Call For Input regarding Ofgem's suggested possible changes to the future regulatory mechanisms. We have met with Ofgem to seek to better understand its ideas for possible changes to the cost of debt and RAV indexation mechanisms for future price controls. We recognise that Ofgem is at a relatively early stage of considering possible changes. This response does not offer views on the individual options because different members can interpret Ofgem's high-level proposals differently.

The current arrangements are very complex in nature and were developed after considerable consultation and detailed analysis of options. Any new, forward-looking mechanism being considered for future price controls needs to be well evidenced and very carefully explored through an extensive consultation process. We must take care to avoid making inappropriate changes to mechanisms that are designed to work on a long-term basis in response to one-off events.

It is not currently clear that any of Ofgem's proposals represent a clear improvement to the current framework.

Frontier Economics sets out views on the issues arising from the potential changes to future price controls suggested by Ofgem and their likely consequences in its report.²³ The report sets out how any of the changes would fundamentally alter key aspects of the price control, risk unintended or detrimental consequences, create practical complexities and additional regulatory burden in implementation and may not fully eliminate the leverage effect. It explains how, as a consequence, careful analysis will be needed in order to assess whether any option offers benefits when compared to the existing arrangements.

The Call For Input is unclear how any consequential changes to other aspects of the price control framework would be considered and managed. For example, several of the proposed options would seem to have significant implications for other hugely important aspects of the framework.

A proper programme of work is required to explore in much more detail:

- how any changes to individual mechanisms would be designed;
- what consequential changes to other aspects of the price control framework would be required;
- any transitional arrangements that would need to be put in place; and
- whether the changes result in an appropriate financing and price control package overall.

Given the importance of the mechanisms in question, this process must be given appropriate time and resources; it must not be rushed.

Ofgem has explained that it intends to conduct an ongoing programme of work to explore in detail any possible changes to the framework for future price controls. We will continue to support Ofgem with this work.

Any changes to the future price control framework must be robustly tested to ensure that they do not create un-intended consequences that have adverse effects for customers

Any changes to future price controls that arise as a result of this process must be subject to robust, multi-faceted analysis that considers the advantages and disadvantages of the possible change, as well as any consequential impact on the operation of other components of the price control and the package as a whole.

Great care must be taken to robustly test any options under consideration to check that they improve the framework in a way that is in customers' interests and do not create un-intended consequences that have adverse effects. If Ofgem cannot be certain that the impact of any change will improve the design of the price control, the change must not be made.

Ofgem's criteria for assessing possible future changes need to be augmented by consideration of any consequential effect on other aspects of the price control package, such as NPV calculations supporting investment appraisals and revenue timing adjustments.

Analysis should also consider more holistic aspects of the price control such as:

- Impact on customer bills – including inter-generational differences and stability of network charges;
- Implications for incentive properties and incentive strength; and
- Impact on investability/ ability to compete for finance in global markets.

Networks will continue to work with Ofgem to assess the appropriateness of any possible changes to the framework for the next price controls

Real cost of debt allowances and indexation of the RAV by inflation are key components of the wider investor proposition and financeability package.

²³ Frontier Economics, Comment on Ofgem's Call For Input on the effect of high inflation, 25 September 2023, section 3.2.

We have previously provided evidence to Ofgem as part of its FSNR consultation of the need for a step up in the investor proposition in the next price controls in order to attract the significant additional capital required to fund the additional investment required to deliver net zero and energy independence. The issue and possible policy options considered in the Call For Input will be best considered as part of this wider piece of work. We will continue to work with Ofgem to support this important programme of work.

Appendix 1 - Overview of relevant current obligations

Obligation	Overview of requirement*	Relevant licence condition reference		
		RIO-GD2 and RIO-GT2 licence	RIO-ED2 licence	RIO-ET2 licence
Credit Rating	Licensee must take all appropriate steps to ensure that it maintains an investment grade credit rating. Includes financial resilience reporting for some sectors.	SSC A38	SLC 40	SLC B10
Availability of Resources	Board of directors evaluates any proposed dividend payment and certify that the making of that payment itself, or when it is taken with other reasonably foreseeable circumstances, will not cause the licensee to be in material breach of the specified licence conditions; and Certify that the licensee's directors have a reasonable expectation that the licensee will have sufficient financial resources and financial facilities and operational resources respectively to enable the licensee to carry on the Distribution/ Transmission Business for a period of 12 months from the date of the relevant certificate.	SSC A37	SLC 30	SLC B7
Pre dividend certificate of compliance	Directors formally certify that the licensee is compliant with a wide range of relevant obligations and that the making of a distribution would not cause it to become non-compliant.	SSC A37	SLC 30	SLC B7
Restriction of Activity and Financial Ring Fencing	Restricts the activities that the licensee can undertake, including investment activities. Requires that a licensee has in force a system of treasury management operations internal controls	SSC A36	SLC 29	SLC B6

Obligation	Overview of requirement*	Relevant licence condition reference		
		RIO-GD2 and RIO-GT2 licence	RIO-ED2 licence	RIO-ET2 licence
	that complies with best corporate governance practice.			
Indebtedness	Restricts the type of financial transactions and arrangements that licensees can enter into.	SSC A39	SLC 41	SLC B9
Prohibition of Cross Subsidies	Prohibits any cross subsidy between the licensee and any other activity or company in the same ownership group.	SSC A35	SLC 4	SLC B5
Undertaking from the Ultimate Controller	Requires commitment from the holding company that owns a licensee that it and other companies in the same ownership group will refrain from action that would be likely to cause the licensee to breach any of its obligations under the Act or this licence.	SSC A26	SLC 31	SLC B8
Regulatory financial performance reporting (RFPR)	RFPR requires considerable reporting related to dividends and dividend decisions including: <ul style="list-style-type: none"> the level of any dividends; a reconciliation to statutory accounts; a split of regulated and non-regulated business dividends; an explanation of approach to dividends; details of where decisions reside for dividend policy; and an explanation of dividend policies and consideration of long term financial sustainability 	SSC A 40	SLC 46	SLC B15

* Note that the obligations are detailed in nature. These simplified explanations provided to assist stakeholders' understanding. They are limited to those aspects of the obligation that are most relevant to the matters considered in the Call For Input. For more detail, please refer to the licence conditions themselves.

Additionally, if a licensee's actual gearing is greater than the notional gearing level, any tax benefit derived from its higher tax-deductible interest costs is automatically clawed back and shared with customers. This creates a further disincentive to introducing highly geared actual company financing structures.

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