

NGN Response to Ofgem's Call for Input on the impact of high inflation

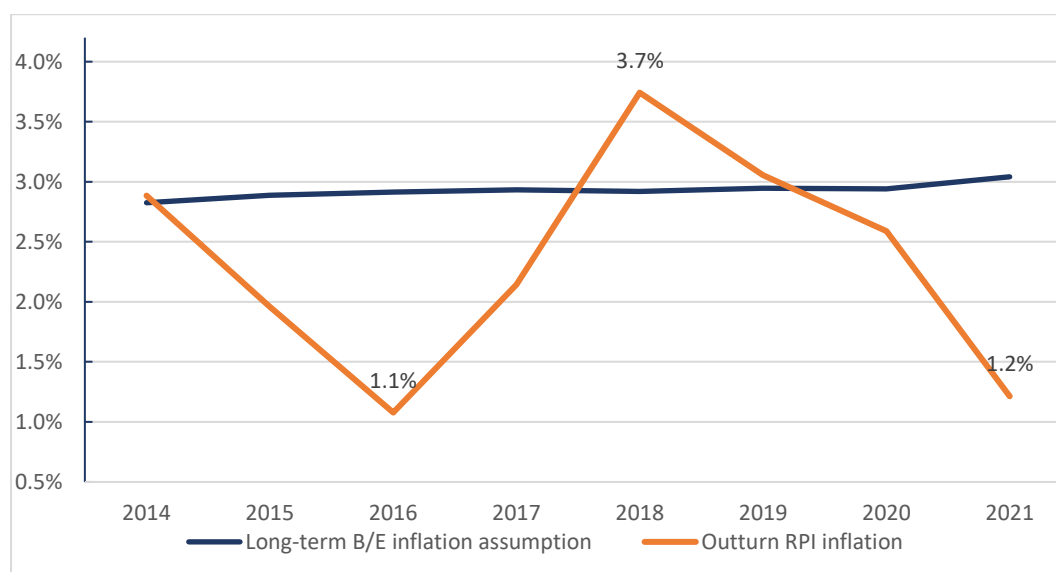
25 September 2023

Introduction and Summary

We welcome the opportunity to respond to Ofgem's Call for Input (CFI) on the impact of high inflation. This paper provides NGN's comments and responses to the questions asked by Ofgem. This submission complements and should be read alongside the industry response¹ on this topic submitted by Energy Networks Association (ENA) on behalf of the energy networks, and the associated paper prepared by Frontier Economics². We provide an NGN-specific perspective where appropriate and aim to avoid unnecessary duplication with the above-mentioned papers. For the avoidance of doubt, if we do not mention or expand on any particular point made in the ENA or Frontier submissions on inflation, this should not be interpreted as NGN's disagreement with its validity or significance.

Inflation is intricately woven into the fabric of the economy and our lives. That said, inflation didn't make headlines for about a decade as it had been rather low and relatively stable. For most of RIIO-1 when outturn inflation was lower than long-term regulatory assumptions (see chart below), equity holders had been sustaining lower real returns than would otherwise be expected. We note that during these periods when inflation was below the regulatory assumption, no policy action was contemplated.

Figure 1: Long-term B/E inflation assumptions vs. outturn RPI inflation in RIIO-GD1



¹ Energy Networks Association, response to Ofgem's Call For Input - Impact of high inflation on the network price control operation, September 2023.

² Frontier Economics, Comment on Ofgem's Call for Input on the Effect of High Inflation. A report prepared for the Energy Networks Association, 25 September 2023.

However, in 2022, amidst unique macro events such as the post-Covid recovery and the Ukraine war, inflation rates began to move above their typical bands. In the wake of this, Ofgem has identified a potential concern with what it calls the “leveraging effect” and is considering whether a policy response of some kind is needed to address non-typical inflation.

Ofgem recognises that the system of RAV indexation with a real WACC allowance has been a cornerstone of the regulatory framework³ – we agree with this characterisation, and it reflects an approach that has been in place since privatisation. The existing arrangements are functioning in line with their long-standing design principles. They have served customer interests well by attracting a substantial amount of investment in upgrading and maintaining our network at an efficient cost of capital, which enables us to fulfil all regulatory outputs and deliver exceptional customer service.

We also agree with Ofgem that the estimation of the quantum of the “leveraging effect” is far from straightforward and can range significantly depending on the inputs and assumptions. In any case, the impact to date of this effect on customers has been largely immaterial, given the long-term nature of the return of/on invested capital.

Some of the more significant policy changes envisaged by Ofgem have the potential to materially harm investor confidence and hence customers’ interests – especially if Ofgem decides to retrospectively re-write the terms on which RIIO-1 and RIIO-2 were set. For these reasons – which we expand on further below and which are also set out in the ENA response and Frontier paper – we hope that Ofgem will naturally reach the conclusion that any retrospective intervention should be avoided.

It is important to note that central banks around the world and in the UK have responded decisively to the recent macro events, which means it is reasonable to believe that a more typical inflation environment will soon return and continue to persist over the long run. We therefore do not consider that a temporary macroeconomic shock necessitates even the prospective fundamental amendments of the current long-established regulatory arrangements. That said, we recognise that Ofgem may want to conceptually assess the regulatory framework in terms of the impact of these particularly unusual and rare cases. If Ofgem takes forward proposals to address extreme eventualities in the future, any change can only be made on a prospective basis; subject to a comprehensive impact assessment and consultation; and implemented over appropriate timescales to allow investors and companies to adapt should they need to.

We note at the outset that Ofgem’s description of its proposed policy options is relatively brief and high-level. The CFI is therefore lacking in full detail and leaves a substantial number of questions about what Ofgem is actually proposing to do, and precisely how any of its proposals would be implemented. The specific details matter and consequently, as it stands, we are unable to properly assess the merits of Ofgem’s proposals. We therefore anticipate the need for a substantially more thorough consultation process should Ofgem intend to take any of the policy proposals forward.

NGN has always been and continues to be a trusted partner and we are willing to support Ofgem in refining regulatory policies to better protect the customers and investors, including against unusual and rare events, if Ofgem views that as necessary. In the remainder of this paper, we respond to each of Ofgem’s seven questions in turn.

³ Ofgem CFI, page 3: “For the avoidance of doubt, inflation protection is considered a cornerstone of our price control framework”.

Question 1. Have we characterised the issue accurately?

No, we do not consider that the issue has been characterised accurately in all material respects.

The “leveraging effect” arises when the outturn CPIH (used to inflate RAV and Revenue) is higher or lower than a long-run inflation assumption, used to derive the real Cost of Debt allowance. For companies with less than 100% of index-linked debt, real equity returns rise (or fall) if CPIH is higher (or lower) than had been assumed. The extent of this impact on returns varies by each licensee depending on the proportion of index-linked debt (whether direct issuance or swapped to an inflation basis using derivatives) held in their portfolio.

If outturn inflation is not inherently or persistently skewed above or below the long-run assumption, this leveraging effect would be expected to broadly balance over time, ultimately resulting in zero overall gain or loss for investors (as Ofgem recognises⁴). However, a large peak of inflation in absolute terms (even over a short period) could result in an unexpected increase in equity returns (or indeed lower returns, should an inflation peak be followed by a sharp trough).

We consider that Ofgem needs to clarify a number of significant aspects of its characterisation of the issue. Firstly, Ofgem says that it has a “*key policy objective of keeping real equity returns stable relative to inflation over time.*”⁵ – with the implication that this has been a long-held policy objective. Ofgem may be referring to the fact that it sets an **allowed** base cost of equity in real terms⁶, but we are not aware of Ofgem ever having established a policy intent of keeping **outturn** real equity returns stable relative to inflation. Ofgem refers to the RIIO-ED2 Finance Annex,⁷ but the page it refers to makes no reference to a “policy intent” of keeping outturn real returns stable.

The CFI goes on to state that this “policy intent” is one of Ofgem’s key motivations for its current consideration of whether to remove or reduce the “leveraging effect”.⁸ However, to the best of our knowledge, no such policy intent has been communicated to us prior to Ofgem’s CFI.

Several other aspects of Ofgem’s characterisation could also be improved and made more precise.

- As explained further below, the quantification of the “leveraging effect” (and the discussion of policy responses) is complex, with many variables to be considered. In particular, company-specific capital structures and financing arrangements are critical. Companies’ actual gearing and the proportion of index-linked instruments will deviate from the notional assumptions used by Ofgem, and therefore the extent of any “leveraging effect” estimated for the notional business will not accurately measure the actual effect for any actual business.
- The term “leveraging effect” which has been deployed by Ofgem is misleading – the effect Ofgem identifies is not related to leverage per se. The use of this terminology has the potential to be misunderstood by

⁴ Ofgem CFI, page 2: “Ordinarily this effect would not be considered detrimental as it would be expected to broadly balance over time”.

⁵ Ofgem CFI, page 1. See also page 3: “We wish to emphasise we are not considering changing the overarching inflation protection principle of keeping real equity returns stable relative to inflation.”

⁶ This is important to be consistent with indexing the RAV to inflation and the long-held policy of offering inflation protection to investors.

⁷ Ofgem CFI, footnote 7.

⁸ Ofgem CFI, page 2: “This Call for Input considers the issue that in reality, where inflation deviates from the long run assumption, real equity returns can vary in a manner inconsistent with the policy intent”.

stakeholders who are less close to the subject matter, particularly given recent negative press coverage of developments at Thames Water and the water sector more generally. In our view, the term carries a negative connotation and may lead to misinterpretations, implying erroneous actions or even deliberate misconduct by network companies, which is not the case. We would urge Ofgem to adopt more appropriate terminology (e.g. Frontier's earlier paper in response to the RIIO-ED2 Draft Determination refers to it as an "Inverse Inflation Exposure"), or at least ensure stakeholders are clear that Ofgem's terminology does not imply any misconduct by the networks.

- Ofgem broadly appears to characterise the leveraging effect as having benefited investors at the expense of customers. However, as Frontier point out⁹, the "leveraging effect" in fact represents a transfer of value between equity holders and nominal debt holders when inflation is different from expectation, rather than between companies and customers. This is because taking on nominal debt exposes both debt and equity holders to opposite sides of an inverse inflation risk - so when inflation is different than expected, there is a value transfer between the debt holders and the equity holders. The alternative to issuing nominal debt is to issue index-linked debt, whereby equity holders and debt holders are shielded from inflation risk.
- Ofgem repeatedly describes the "leveraging effect" as generating "outperformance or underperformance". This is a mischaracterisation – outperformance/underperformance typically refers to operational incentives that are within the control of company management (as Ofgem itself recognises later in the CFI¹⁰). The leveraging effect is the outcome of risk exposure for equity investors to macro-economic conditions – a risk exposure which is consciously taken on by equity investors in cognisance of the terms of the regulatory framework specified by Ofgem. Indeed, as Ofgem states in the CFI, under the current framework: *"licensees could reduce their respective equity exposure to the leverage effect via the use of index linked debt or derivative instruments ("ILD"). The extent of their application or non-application would be a choice of financing policy for licensees with the risk and rewards of such decision residing with shareholders."*¹¹ - this is an accurate description of how we have understood the framework to operate to date and since privatisation. More appropriate terminology would be "macroeconomic risk exposure" rather than "out/under-performance". Importantly, it is impossible to predict in advance how an inverse inflation exposure would perform – rather, equity investors have actively chosen to take on an (unpredictable) risk exposure as part of the overall financial risk-return balance associated with investing in regulated assets.

⁹ Frontier Economics, Comment on Ofgem's Call for Input on the Effect of High Inflation. A report prepared for the Energy Networks Association, 25 September 2023, p.18.

¹⁰ Ofgem CFI, page 7. Ofgem says the leveraging effect "is a result of an economic sensitivity inherent within the price control and is not associated with business performance or outcomes for the consumer".

¹¹ Ofgem CFI, page 3.

Question 2. Have we adopted an appropriate approach to the quantitative assessment? Responses to the question should consider the relevant factors listed on page 4, the accompanying financial model and model user notes.

Significant reservations remain with Ofgem's quantitative assessment of the "leveraging effect".

Ofgem's initial analysis finds that the leveraging effect results in circa £1.5bn of "excess" RAV growth for the networks overall, over the period FY13 – FY23. The equivalent figure for NGN only is c. £21m.

We have engaged extensively with Ofgem on the modelling through the ENA Finance Working Group and as a result, we do not consider that Ofgem's modelling contains significant methodological errors. However, we refer Ofgem to the paper by Frontier Economics for a discussion of where some quantification issues remain. For example, Ofgem has not taken account of the basis risk between CPI and CPIH (albeit this issue would only become relevant if Ofgem proceeds with specific options, hence we do not expand on it here). We refer Ofgem to the full discussion of these issues in Frontier's paper, Annex B.

More fundamentally though, we consider that the results of Ofgem's quantitative assessment are circumstantial and entirely dependent on the arbitrary selection of the evaluation period and what happens during that period. Ultimately, no specific period would be "correct" – which is why we consider any assessment of the "leveraging effect" would be fundamentally arbitrary. Therefore, while the mechanical calculations are directionally reasonable (subject to the caveats noted above), the calculations in our view cannot be relied upon to make regulatory policy decisions.

Another critical issue here is that Ofgem's calculation of £1.5bn for the sector (or £21m for NGN) relates to the notional capital structure and therefore it does not represent the actual "excess" gain/loss that could have accrued to shareholders. To emphasise the importance of this, we calculate that if NGN's **actual** capital structure is used, the "excess" RAV growth over the same period for NGN arising from the "leveraging effect" is only around £3m (rather than £21m) using Ofgem's published Model. However, if one were to adopt an alternative calculation methodology and factor in just one of the factors that were disregarded by Ofgem (the CPI/CPIH wedge), the calculation result would show a "deficit" in RAV terms of c.£4m, indicating a value loss of even larger magnitude.

Ofgem also invites comments on the discount rate used to present outputs in net present value terms. Conceptually we agree with Ofgem's choice of using annual nominal WACC as discount rates – however, we note that the WACC and inflation will of course evolve over time, hence the exact values after 2023 may need to be updated, should a need to use them remain.

Question 3. What are stakeholders' views on the policy options outlined and the associated benefits and risks associated with each option? Are there areas where the policy options outlined could be optimised? Please see the policy option section on page 7.

Ofgem sets out five possible policy options on which it seeks comment. These are:

- Option 1: No policy action in relation to the “leveraging effect” (i.e. retain the existing arrangements);
- Option 2: Distribution policy reporting and transparency (to ensure reporting consistency and consider whether enhanced measures are required);
- Option 3: Changes to future price control design (four sub-options are presented, that Ofgem considers may have the potential to reduce or remove the “leveraging effect”);
- Option 4: Out or underperformance true up (in effect retrospectively introducing a true up at the end of RIIO-2 to adjust for any over/under growth in RAV that has arisen from the “leveraging effect”); and
- Option 5: Voluntary submissions by licensees (to share any benefits of inflation-driven equity outperformance with consumers).

To the extent possible, given the insufficient level of detail provided by Ofgem, we offer initial comments on each of these Options below.

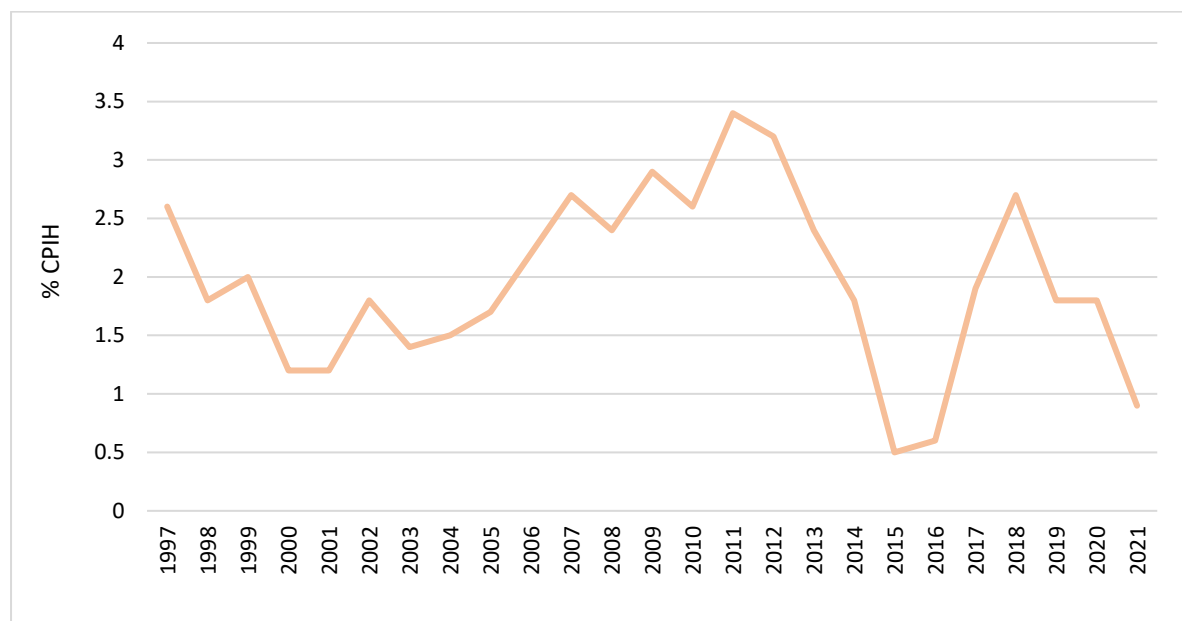
Option 1: No policy action in relation to this issue

The mechanism of indexing RAV over time and using a real WACC is part of an overall system which is described as providing ‘inflation protection’ for energy networks. In our view, the system has served to attract capital at a low cost. Indexing the RAV to outturn inflation has been a fundamental component of the regulatory model since privatisation – not just for energy networks but across regulated infrastructure sectors generally. This approach has been a key underpinning of investors’ understanding of the risks associated with investing in network assets. Business decisions have been taken over decades in reliance on this long-standing indexation approach.

Further, there is no particular reason to believe that – in expectation and over time – the potential existence of a “leveraging effect” will lead to companies receiving more or less than Ofgem’s intended level of allowed return. The very high inflation in the last year has been caused by highly rare events (a combination of the pandemic and the war in Ukraine). The Bank of England has reacted by tightening monetary policy and says it is committed to returning inflation to its long-run target. There is no reason to suppose that we won’t return to a situation where inflation fluctuates around its long-run target.

Indeed, over two decades prior to recent events, we had observed that CPIH inflation had generally fluctuated around c. 2%. The chart below shows CPIH from 1997 (when the Bank of England became independent) to the end of 2021. On average over that window, CPIH was below 2%.

Figure 2: CPIH inflation rate in 1997-2021



Source: Frontier Economics

Given this, the outcome of the “leveraging effect” in RIIO-2 is uncertain, circumstantial, not systematic, and thus provides no compelling reason to change regulatory arrangements.

We also note that under the current model, the effect of the temporarily higher outturn inflation will only flow through into cashflows (and hence customer bills) over a very long time horizon i.e. accruing in the RAV before being released through depreciation of and return on RAV over 45 years. As noted above, the “leveraging effect” experienced by NGN (over the time horizon Ofgem has selected and using Ofgem’s methodology) is only c.£3m based on NGN’s actual financial structure. For NGN’s customers, this amounts to a negligible 10 pence per year on their energy bills.

Therefore, the overall effect of the current arrangements on networks and customers provides no compelling reason to change arrangements that have underpinned ongoing, large-scale investment at competitive rates of finance over several decades. Furthermore, some of the alternative policy options (as described below) are likely to have harmful effects and/or unintended consequences.

Option 2: Distribution policy reporting and transparency

The existing Licence conditions and the Regulatory Instructions and Guidance (RIGs) on annual Regulatory Financial Performance Reporting (RFPR) already contain a very comprehensive set of rules and obligations to regulate companies’ distribution policies.

For example, *Standard Special Condition A37: Availability of Resources* requires the licensee by 31 July each year to give Ofgem a certificate that has been approved by a resolution of the Licensee’s board of directors and signed by a director of the Licensee to certify that “...having taken into account in particular (but without limitation) any dividend or other distribution that might reasonably be expected to be declared or paid by the licensee” the licensee will have sufficient financial resources to carry on the transportation business for a period of 12 months. SSC A37 further stipulates that “the directors of the licensee must not declare or recommend a dividend, and the licensee must not make any other form of distribution” before

certifying to Ofgem that the Licensee is in compliance with all of the obligations imposed on it by *Standard Special Condition A26 (Provision of Information to the Authority)*, *Standard Special Condition A36 (Restriction on Activity and Financial Ring Fencing)*, *Standard Special Condition A37 (Availability of Resources)*, *Standard Condition 45 (Undertaking from Ultimate Controller)*, *Standard Special Condition A38 (Credit Rating of the Licensee and resulting obligations)* and *Standard Special Condition A39 (Indebtedness)*; and that making of a distribution, will not cause the licensee to be in breach to a material extent of any of those obligations in the future.

The RIIO-2 RFPF guidance document instructs that *“Licensees must provide an explanation of dividend policies and dividends declared and paid, and how these take account of long-term financial sustainability, including delivery for customers and other stakeholder obligations. This should cover all dividends which licensees declare, and pay, including those which may be retained within the corporate group, including to service group debt or cover other costs, and not immediately paid up to external shareholders”*.

Moreover, there are indirect tools and mechanisms within the price control framework, which incentivise energy networks to maintain their capital structures in line with Ofgem’s notional assumptions. For example, there is the Tax clawback adjustment, which takes effect if a Licensee’s actual gearing is greater than the notional gearing level, with any tax benefit derived from its higher tax-deductible interest costs being automatically clawed back reducing the network’s tax allowance. This creates a disincentive to introducing highly geared actual company financing structures.

NGN has always complied with all Licence requirements and acted responsibly, transparently and in the consumer interest when making annual distribution decisions and reviewing our distribution policies. By way of example, in 2009/10 when inflation was low, we reduced our distributions by c. 60% to maintain a stable level of gearing and sufficient headroom above minimum credit metric thresholds commensurate with a comfortable investment grade credit rating. However even in 2022/23 when inflation was high and our credit rating was confirmed at BBB+/Baa1, we utilised an additional RAV capacity to further bolster our financial resilience – we paid out even lower dividends than in the previous regulatory year. We will continue to pursue a rational and prudent financial strategy, acting in the customer’s interests in all respects of our activity, including when it comes to dividends.

We, therefore, consider that comprehensive controls to ensure the financial resilience of the Licensees are already in place for GDNs. That said, if Ofgem believes that the quality or presentation (format) of disclosures would benefit from improvement, we would welcome an opportunity to work with Ofgem to better understand the regulator’s specific requirements and expectations.

One needs to be mindful that this is a complex area, which may not have simple one-size-fits-all solutions. On the one hand, more detailed guidance may appear to be a welcome feature facilitating compliance and enabling companies to report information in a more intelligible or consistent way. On the other hand, it is crucial to ensure a well-thought-out and measured approach when deciding on the specific detail and wording of policy formulation, particularly in relation to dividends, as an overly prescriptive set of rules may create unintended consequences.

Ofgem’s CFI signals that it could consider enhancing the existing requirements. We recognise that a prudent regulator has to secure high levels of compliance, consistency and public transparency of the reporting. We also understand in principle Ofgem’s goal to ensure that there is a clear and transparent evidence base for demonstrating that a licensee’s distribution policies and decisions on quantum are appropriate for the outturn performance achieved. However, companies’ dividend policies and the associated decision-making processes are multi-faceted and complex – it may not always be possible to draw out a mechanical link between business performance in any particular reporting year and the quantum of distributions in the same year. The timing of cash flows and performance are not necessarily aligned – the snapshot of

performance in any given year is often a function of longer-term initiatives and investments made over an extended period of time, overlaid by a unique set of operational circumstances and financial environment prevalent in a particular estimation period.

In any case, none of the potential modifications in this area would appear to have the effect of changing how the “leveraging effect” works, and therefore this policy option in our view should be considered (if needed) independently of the discussion around the regulatory treatment of inflation.

We encourage Ofgem to work closely with companies and the sector as a whole to explore constructively what if anything may need fine-tuning and refining in terms of the existing distribution policy reporting and transparency requirements.

Option 3: Changes to future price control design

We refer Ofgem to the detailed consideration of these options provided in the ENA response and supporting Frontier Economics paper. We do not repeat those points here, except to emphasise our view that we believe the status quo arrangements are not inherently flawed. However, we recognise Ofgem may see a need to fine-tune those arrangements to work differently in the event of extreme and highly unusual inflationary environments which persist over an extended time. We are willing to work with Ofgem in considering the pros and cons of potential alternative approaches.

We note that one of Ofgem’s *“principles for policy design and implementation”* is that it will seek to manage *“the pace of implementation”*. We welcome Ofgem’s signal that it would look to provide *“appropriate transition timeframes to enable licensees to make necessary adjustments to adapt to a policy change, for example, making changes to their capital structures. An appropriate timeframe would vary with the option ultimately adopted and, for example, could involve a transition timeframe spanning multiple years or price controls.”* We agree that this is an important consideration and we note that many financing positions already adopted involve long-dated debt instruments. We therefore anticipate that any policy implementation is likely to require a lengthy implementation timeframe in order to provide sufficient scope for investors to adapt their risk exposures to a new model (if that is introduced).

We are also firmly of the view that if Ofgem intends to take forward further consideration of these prospective arrangements, then it would make the most sense to incorporate that into the broader price control process – for example by providing for development and consultation on the options in the RIIO-3 Sector Specific Methodology Consultation. We understand this is Ofgem’s intention and consider that Ofgem would need to provide considerably more detail on the design of these options in order to allow us to complete a full appraisal of each of them. Frontier Economics have set out in their report how the proposals could 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 “leveraging effect”. We note that there are many design choices Ofgem might make, and even minor design differences could have profound implications for the operation of the price control.

We would therefore welcome further clarification and engagement with Ofgem on this through the next price control review process for gas distribution networks. For the benefit of any future detailed consultation, we would emphasise a number of points that Ofgem should place weight on.

- Ofgem should avoid retrospective intervention that will substantially harm investor confidence (see further discussion in response to option 4 below).
- Any option adopted by Ofgem should be considered as part of the overall financial package for RIIO-GD3. Any material re-allocation of risk between customers and investors should be taken into

account for the calibration of the key elements of the Allowed Cost of Capital for GDNs. For example, to the extent that any of the prospective changes remove or reduce the long-established principles and practice of inflation protection priced into the current levels of the cost of equity for utilities, this will inevitably have the effect of increasing such cost of equity, let alone causing wider collateral implications, e.g. on the willingness to invest and/or take additional risks at extending the efficiency frontier.

- The overall WACC allowance calculation methodology must remain consistent with the core tenets of financial theory. For example, the pricing of long-run debt is essentially forward-looking and based on prospective expectations, not outturn inflation.¹²
- Any alternative long-run inflation forecast that is used must be grounded in clear, non-biased evidence. As it stands, we consider that:
 - o There is no obvious reason to materially deviate from c. 2% in principle, which has been the BoE's target for a long time, and given the BoE has acted and continues to do so decisively in response to the recent extreme events in order to bring inflation back to target.
 - o Any change Ofgem makes to long-run inflation expectations must be genuinely and unequivocally forward-looking, not backward-looking. I.e. even if Ofgem chooses to move away from using the OBR forecast year 5 value, it would be incorrect (and arbitrary) to e.g. select some historical CPI average or adopt a short-term forecast. The long-run inflation value must still be based on independent, widely recognised and respected forecasts, taken over an appropriately long time horizon. The precise calibration details are important and must be comprehensively consulted upon.
- Any prospective methodology should be careful to avoid introducing undue or material year-on-year volatility (e.g. through the operation of a new RAM; or through taking short-term/volatile inflation values).

Option 4: Out or underperformance true-up

As set out in the ENA response and Frontier Economics paper, this option would represent an unprecedented renegotiation of already agreed past price controls. This would be tantamount to changing key aspects of those past price controls to arbitrarily confiscate some part of RAV, that has accrued in line with the agreed terms of the regulatory contract.

Such a decision would put a major dent in investor confidence and in their view of the predictability and stability of the regulatory framework, which is critically important for attracting investment. This view has been confirmed by Moody's, who stated that "such a change would undermine investor confidence in the predictability and stability of the regulatory regime when significant investment is required"¹³. Indeed, Moody's view was that Ofgem does not seriously intend a retrospective clawback, stating that "*we believe*

¹² We observe that such an outcome has occurred in Northern Ireland, following the introduction of an inflation true up for the allowed cost of debt as part of the GD23, a mechanism that resembles Ofgem's sub-option 3(i). Notably, this change in arrangements by UR provoked a negative reaction – e.g. Moody's stated that "PNG's credit quality is constrained by a deterioration in the stability and predictability of the regulatory regime. Significant changes to the framework were introduced without consultation late in the process relative to the 2023-28 regulatory period (known as GD23), including a novel inflation adjustment)." [emphasis added]. See Moody's (2023) Phoenix Natural Gas Limited, Update to credit analysis following final determination.

¹³ Moody's Investors Service. Regulated Electric & Gas Networks – Great Britain: Ofgem outlines possible changes following high inflation. 3 August 2023, p.4

the most radical option, for example by clawing back retrospective outperformance in RIIO-2, was included largely for completeness”¹⁴. Nevertheless, the fact that the proposal has even been made by Ofgem at this point is already likely to have caused a degree of concern in the investor community.

It is clear that Ofgem accepts such long-term harm to investor confidence is likely to be caused and to be material. In discussing this option in the CFI Ofgem states:

“While this option may create some benefits for consumers by removing any temporary “excess” RAV growth (the precise scale of which is currently uncertain due to the aforementioned factors set out on pages 3-4), it could also create significant costs for consumers by undermining the stability and predictability of the regulatory framework if investors perceive elevated regulatory risk, leading in turn to a potentially sustained increase in the cost of capital borne by consumers. This is particularly pertinent in the context of the elevated investment requirements in the near term to facilitate the transition to Net Zero; with relatively small changes to the cost of capital able to outweigh any benefits associated with this option.”

It is important to be clear that – should Ofgem proceed with this option – the detrimental effects could be felt across the board of regulatory arrangements (i.e. if Ofgem proceeds with this option, any rational investor will then understand that **any** formally agreed aspect of a price control determination could, in theory, be unwound later). This therefore has the potential to undermine the efficacy of the whole RIIO regime, including its incentive arrangements and companies’ operational performance.

We note that Ofgem’s policy evaluation criteria around *“Regulatory stability and predictability”* is critically important here. We think that the risks associated with pursuing this option are extremely high: the *stability and predictability of the regulatory regime*, which is currently perceived as high, may be very materially damaged. This would entail a higher cost of capital for the consumer and a reduced investability of the sector for many years to come.

We consider that any attempt to implement Option 4 would unambiguously result in the harmful effects described in Ofgem’s criteria. Again, we refer to the fuller discussion of this topic provided in the ENA/Frontier papers. In short, we fully support the conclusions reached there, and would strongly oppose any retrospective intervention.

Option 5: Voluntary submissions by licensees

As noted above, when considered on the basis of NGN’s actual financial structure we believe the “leveraging effect” ranges from a “deficit” RAV growth of c. £4m (including CPI/CPIH wedge) to an “excess” RAV of c. £3m for NGN using outturn data. Even these figures are based on an arbitrary time period and may need refining as suggested by Frontier Economics. It is also conditional on the inflation forecast used for the remaining years of RIIO-GD2 – and given the inherent uncertainty in those forecasts (particularly in the current volatile inflation environment) there is simply no way that one could confidently calculate a figure to form the basis of a voluntary submission.

More fundamentally, we don’t consider it appropriate to ask shareholders to make such a contribution when it is clear that in future the leveraging effect could work in the opposite direction – meaning shareholders are asked to voluntarily return to customers supposed “gains” they may have made over an arbitrary evaluation period, but to bear the burden of any losses going forward. It is also not appropriate

¹⁴ Ibid

to make voluntary contributions given that investors have been told by Ofgem to date that the financing strategies they adopt are their own choice to make, and that they will bear the consequences of those choices. In effect, were Ofgem to ask for voluntary contributions, all the same harms that arise under Option 4 would likely materialise under this option.

Question 4. Should any other policy options be considered?

There are already an extensive set of policy options in Ofgem's CFI. While it is possible that other options could emerge as this issue is discussed further, we do not at this time have any specific additional proposals.

Question 5. Are the principles proposed for policy formulation complete and appropriate?

Yes, we consider that the three principles identified by Ofgem as “*key for the formulation of any policy action in its design and implementation*” are appropriate. We provide our views on each principle as follows.

- **Financial resilience.** We agree this is critical. It is likely to be challenging to assess this robustly on a forward-looking basis, in the context of a potentially volatile inflation environment in the short-term. We agree with Ofgem’s view that this has implications for the appropriate transition timeline.
- **Policy symmetry.** We agree with this as an objective. We note that there is no reason to suppose in expectation and when assessed over the long term that the existing arrangements are likely to be asymmetric. We reiterate our view that it is misleading and a mischaracterisation to refer to the “leveraging effect” as an “*outperformance opportunity*”.
- **Managing the pace of implementation.** We agree that proper consideration of transition timelines is critical, given (as explained above) that long-dated financing decisions have already been made and sunk on the basis of Ofgem’s existing framework and its stated policy intention that “*licensees could reduce their respective equity exposure to the leverage effect via the use of index linked debt or derivative instruments (“ILD”). The extent of their application or non-application would be a choice of financing policy for licensees with the risk and rewards of such decision residing with shareholders.*”¹⁵ This has been our understanding of Ofgem’s policy as applied to date since privatisation.

It is of course important always to adhere to the principles of good regulation and avoid unnecessary harm to investor confidence – we see this as unambiguously in customers’ best long-term interests.

¹⁵ Ofgem CFI, page 3

Question 6. Do the proposed evaluation criteria comprehensively consider the consumer interest in respect of this issue? Are there modifications or additional criteria that stakeholders would suggest?

We consider that while the evaluation criteria do broadly capture the consumer interest, some aspects are misplaced. We provide further comments on each of Ofgem's criteria below.

- **Protecting consumer interests.** We would emphasise that the consumer interest must be considered in the round – and must not be limited to Ofgem's quantitative estimates of the bill impact or Ofgem's arbitrary "leveraging effect" estimate. Further, Ofgem suggests that a policy that results in "equity outperformance" is by definition not in consumers' interests, but this is too narrow an interpretation of the interests of consumers – as explained above, the system of inflation protection that has been in place since privatisation has underpinned the attraction of huge capital investment in the network sectors, and at a very efficient cost of capital. This has contributed to substantially improved customer outcomes. At this critical juncture for delivering Net Zero, with all network sectors likely to require substantial further investment over the coming decade, it is critical that Ofgem recognises that the ability to attract investment and to do so at efficient rates, is central to protecting consumer interests.
- **Ensuring prices are fair for the consumer and are efficient.** The consideration of this criterion must reflect the fact that the "leveraging effect" arises from a transfer of risk between debt and equity holders (rather than between customers and investors). It is also important to place the magnitude of the impact of the "leveraging effect" into its proper context in terms of the relatively small impact on annual customer bills.
- **Regulatory stability and predictability.** We entirely agree with Ofgem that *"policy action, particularly if it was not anticipated or in line with accepted best practice, may impact the perception of the stability and predictability associated with the regulatory regime. Regulatory stability underpins the ability to minimise perceptions of risk and the cost of capital for the consumer. It is also key to investor confidence and the investability associated with the sectors we regulate over the long term. It is possible policy action may raise the cost of capital to consumers to the extent it offsets the likely benefits of such an action."* Regulatory stability and predictability are critical to underpin investor confidence, attract investment, and minimise the required cost of capital. Given that Ofgem's policy options relate to one of the most fundamental cornerstones of the regulatory framework, this criterion should be given particular prominence in any assessment of the options, particularly in light of the challenges of delivering Net Zero.
- **Optimal allocation of risk.** Neither network companies nor network customers can influence macroeconomic variables such as inflation, so it is not clear to us that this criterion can have any meaningful role in assessing the policy options. Further, Ofgem's statement that *"the removal of the inflation leverage effect for example could reduce inflation risk for both consumer bills and network returns."* is misplaced - inflation risk is not reduced as a consequence of the policy options Ofgem is considering, rather the policies would modify who bears what types of risks under the regulatory framework vs. the status quo. We also do not understand Ofgem's statement that the allocation of this risk could *"improve the incentive framework for efficient performance"* – to our knowledge, Ofgem is not seeking to incentivise key choices companies may make around how to

finance their business (e.g. whether to issue index-linked vs. nominal debt); and nor do the issues raised in the CFI have any relevance for any operational incentives under RIIIO. We do agree, however, that Ofgem's policy approach will have implications for both the "*efficient cost of capital*" and "*how the allocation influences the complexity of the control*" – so we agree that these factors must be reflected in any future policy assessment.

- **Price control legitimacy.** Ofgem must be careful not to characterise equity returns arising from risks (which may have resulted in lower equity returns in different circumstances) as being implicitly illegitimate. We do not believe customers or their representatives had any concerns about price control legitimacy during the periods when inflation was below the expectations baked into the cost of debt allowances. Ultimately we have experienced 2 years of extreme inflation which has so far resulted in a relatively small impact on customer bills – this suggests customers should continue to view the system as legitimate and recognise that long-term customer interests are served by the system of inflation protection that has operated to date.
- **Credibility of voluntary plans submitted.** As noted earlier, we do not consider voluntary plans to be required or appropriate. Therefore we do not see any role for the application of this criterion. Should other licensees choose to submit voluntary plans, we do not believe there needs to be a requirement for those to be consistent across licensees – hypothetically, any such plans would inevitably be specific to the licensee, given they would be voluntary.

In addition, we refer to the ENA's response to the CFI and the Frontier's paper. These documents identify other aspects that Ofgem should consider, such as the consequences of any policy action on financeability assessment and implications for incentive properties and incentive strength of the RIIIO-GD3 financial package.

Question 7. Is there any further information or are there other factors which should be considered?

Our consideration of this issue to date has not identified any other major factors to consider. We believe that if any Option different from the status quo is to be pursued, a more comprehensive review of factors and their implications should be undertaken as part of a detailed methodology consultation forming part of a wider RII0-GD3 price control discussions.