

Rebecca Barnett

[By email]

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Call for Input – Impact of high inflation on network price control operation

Dear Rebecca

National Gas Transmission (NGT) is the backbone of Britain's energy system today and we are working to play a leading role in the transition to a clean energy future that works for every home and business. We own and operate the gas National Transmission System (NTS) keeping households warm and underpinning their quality of life.

Gas is currently a critical part of Britain's energy needs. This is because we can ensure security of supply; and it is because of our transmission system that we are able to move energy to where it is needed efficiently and quickly. Security of energy supply is something many of us take for granted, but delivering it is a responsibility we take incredibly seriously.

Financial resilience and stability are important components in maintaining our critical role in meeting Britain's energy needs, with indexation mechanisms being an integral part of energy regulation. Protecting the credibility and stability of the regulatory framework in the UK is absolutely vital to attracting the investment needed to maintain energy resilience now, and to facilitate the UK's Net Zero ambitions.

Amending the RIIO framework with reference to one specific financial dimension risks fundamentally altering the balance of risk within the underlying economic model with the effect of downstream increases in the cost of capital for networks, at a point when the UK needs to attract record levels of investment to facilitate Net Zero, particularly if such amendments are akin to reopening existing or previous price control agreements, an assertion Ofgem itself acknowledged during its midpoint review of RIIO-1. This imbalance is magnified where the Call for Input has been issued in response to high inflation over a relatively short period of time, which in itself was driven by global events, and where Ofgem has not sought to intervene in previous periods of lower than average inflation.

If the matter is assessed over an appropriate period of time the estimated benefit accruing is comparatively immaterial given that for NGT the benefit broadly balances over time and is not as a result of sustained out or under performance – both in terms of CPIH indexation of RAV and in the impact on consumer bills. Indeed, the values assessed by Ofgem are lower than the investment NGT made over and above allowances during the RIIO-1 price control.

Using the Ofgem models, accounting for the HM Treasury consensus forecast for inflation to the end of RIIO-2, our analysis shows that:

	£m
• Ofgem estimates NGT RAV growth associated with higher CPIH of £169m, or £189m if notional gearing specific to NGT's RIIO-2 agreement is applied, both of which are less than 3% of NGT's total indexed RAV	169 20 <hr/> 189

Taking into account further factors not addressed by Ofgem's model outlined below fully negates the impact on RAV indexation and results in a negative value of £24m for NGT:

	£m
• The delta between RPI and CPI has been significantly higher than that envisaged by the notional financing structure, the impact of which NGT estimate to be -£55m across the RIIO-2 period	189 (55)
• Higher inflation has resulted in higher interest rates in most territories and as such, the impact of higher inflation cannot be assessed in isolation without taking into account the subsequent impact on interest rates and financing costs. We estimate the impact of these higher financing costs over and above the cost of debt allowances is -£48m over the RIIO-2 period	(48)
• Whilst we understand why Ofgem has modelled the matter in terms of the notional company financing structure, the impact of inflation on NGT is also lower if actual levels of RPI-linked debt are considered. The RIIO framework affords the flexibility for networks to make their own financing decisions and we recognise that putting in place a higher proportion of RPI-linked debt is the company's choice, but the reality of the situation should be taken into account when assessing potential gains. Applying the actual financing structure of NGT to the cost of debt and CPI-RPI wedge calculations referred to above increases their negative impact by a further £110m	(110)
	<hr/> (24)

Whilst we are not in a position to estimate the impacts for all network companies, taking into account these wider factors will significantly reduce the estimated RAV growth across energy networks as compared with Ofgem's modelling done to-date.

We would like to confirm that this period of higher inflation has not resulted in a change to the dividend policy employed by NGT, noting that NGT's gearing ratio at the end of FY23 (net debt/indexed RAV) was below the 60% assumed for the RIIO-2 price control period.

We have laid out our position against the questions tabled in the Call for Input dated 1 August 2023 in the following pages based on the above context.

NGT will also be a signatory to the separate response submitted by the Energy Networks Association (ENA) on behalf of the industry, which is the result of several months of engagement with other members and Ofgem. We therefore support the view expressed in that letter that any action to amend current or previous controls would ultimately be damaging to consumers and any changes to future price controls need to be carefully considered and in the context of the wider price control package. As such, we will continue to support the ENA's continuing engagement with Ofgem to ensure that the next price control financial package results in an appropriate balance of risk between consumers and network firms.

If you would like to discuss these points further please do not hesitate to contact me or our Head of FP&A, Matt Plant (matthew.plant@nationalgas.com).

Yours sincerely,



Tony Nixon
Regulation Director, National Gas Transmission

1) Have we characterised the issue fairly and accurately, including with respect to the choice of historical evaluation period and inflation index for assessing the scale of the issue?

NGT has been of a member of the ENA's working group to engage with Ofgem to develop its approach to quantifying this matter. The ENA has in turn commissioned a report by Frontier Economics to supplement this work. Some minor issues with Ofgem's calculations are laid out in the final report from Frontier which is appended to the ENA's response and are not replicated here. However, this work has identified that Ofgem's calculations do not consider certain aspects of the price control, notably the difference between CPI and CPIH, that should be taken into account when quantifying this matter.

We also believe it is valid to take account of other factors, such as RPI to CPI adjustments in the price control period and have set these other considerations out below.

It appears appropriate to reference the RIIO-1/RIIO-2 timeframe given the change in the structure of price controls from that point and it being a reasonably long period of time over which to assess such a matter. However, we would note that given the sensitivity of the outcome in the remaining years of RIIO-2 to inflation forecasts, the value being presented could prove to be materially incorrect.

Assessing the matter by valuing CPIH indexation of RAV does not appear inappropriate given the impact on gearing levels and on allowances recovered by network firms over the remaining regulatory life of assets. We understand Ofgem's desire to also express the impact as an increase or decrease to consumer bills given the cost of living issues being suffered by end consumers, but we have adopted a calculation that more closely aligns to the consumer bill statistic NGT publishes at the end of each year.

However, it is NGT's view that the impact of higher than expected inflation over a short period of time has not had a material impact on NGT or caused harm to consumers.

The version of Ofgem's model released with the Call for Input letter which incorporates inflation assumptions that align to the HM Treasury May consensus forecast (£3.4bn across the sector for the RIIO-1/2 period) calculates additional CPIH indexation across RIIO-1 and 2 as £169m for NGT using the average notional values for gearing and levels of index-linked debt for the ET/GT/GD portion of the sector. If this scenario is amended for the notional gearing assumed in NGT's specific price control agreements, this increases to £189m.

Both of these values are lower than the investment NGT made over and above allowances during the RIIO-1 price control¹.

Both values also amount to less than 3% of RAV (based on closing FY23 indexed RAV of £7,075m), a proportion that is likely to reduce still further as NGT's continuing investment in the network across the RIIO-2 period results in further RAV growth.

¹ National Grid Gas Transmission Regulatory Reporting Narrative for 2020/21, 30 July 2021: reported £252m overspend against allowances for the RIIO-1 period

A value of £189m equates to a consumer bill impact of up to 8p per customer/year depending on the inflation forecast utilised for the remainder of RIIO-2 and approach taken to adjust for the £189m. This calculation has been performed in a manner consistent with the methodology agreed with Ofgem for annual reporting.

Whilst NGT acknowledges the RIIO framework places an emphasis on ensuring the notional company is financeable and structures cost of equity, cost of debt and financing allowances accordingly, there are two further factors that NGT considers it fair to take into account.

Firstly, the notional financing structure includes an allowance for the difference between CPI and RPI in cost of debt allowances to compensate for the fact that most network companies raise financing that references RPI whilst indexation of RAV and allowances is based on CPIH. This allowance is based on a wedge of c0.8% between CPI and RPI. The actual delta between these two indices has been significantly higher than this in the RIIO-2 period to date and is to forecast to remain so in 2024. NGT estimates the impact of this to be -£55m in the RIIO-2 period.

Secondly, higher inflation has resulted in higher interest rates in most territories and as such, the impact of higher inflation cannot be assessed in isolation without taking into account the subsequent impact on interest rates and their impact on financing costs. NGT estimates that the impact of these higher financing costs over and above the cost of debt allowances provided under the RIIO framework over the RIIO-2 period is -£48m.

Furthermore, both of these estimates are based on the notional financing structure laid out in NGT's price control agreements, which assumes gearing of 60% (net debt/RAV) and a 30% proportion of debt being index-linked. NGT's financing structure is materially different to the notional company in respect of the proportion of RPI-linked debt it carries. Whilst NGT acknowledges the RIIO framework allows this flexibility and the choice of financing structure is for each company to assess, each company's actual experience of the results of higher inflation should be taken into account. As such, applying the actual level of RPI-linked debt to Ofgem's calculations and NGT's subsequent assessment of the CPI-RPI wedge and actual cost of debt would significantly increase the negative impact of inflation over the RIIO-1 and 2 period. Applying the actual financing structure of NGT to the cost of debt and CPI-RPI wedge calculations referred to above increases their negative impact to £213m in total, fully negating the additional RAV indexation resulting from Ofgem's calculations.

The conclusion that NGT has not unfairly benefitted from inflation given the proportion of RPI-linked debt is supported by the annual performance summary released by Ofgem based on Licensee's RFP submissions. FY23 is pending but the outcome presented for NGT is not expected to be significantly different to the FY22 results summarised below:

RIIO-2 period	RIIO-GD2				RIIO-ET2			RIIO-GT2
RoRE based on Notional Gearing	Cadent	NGN	SGN	WWU	NGET (TO)	SPT	SHET	NGGT (TO)
Allowed Equity Return + IQI	4.6%	4.7%	4.6%	4.6%	4.1%	4.3%	4.5%	4.4%
Operational performance - Totex	0.0%	1.0%	0.3%	-1.0%	0.9%	0.0%	0.4%	0.1%
Operational performance - other	0.1%	0.1%	0.0%	0.1%	0.0%	0.3%	0.1%	0.1%
Operational RoRE	4.7%	5.8%	4.9%	3.6%	5.0%	4.6%	4.9%	4.6%
Financing and tax performance	3.2%	3.3%	1.3%	-3.3%	2.1%	2.9%	2.0%	-2.0%
Total RoRE - with financing and tax	7.9%	9.1%	6.2%	0.3%	7.1%	7.5%	7.0%	2.5%

NGT's negative performance in financing arises due to holding a higher proportion of net debt being RPI-linked than both the notional structure on which RIIO-2 Allowed Return calculations are based (c.82% at FY22 v's 30% assumed in notional entity) and other network companies.

NGT recognises that customers, stakeholders and investors must be confident that distributions to shareholders are appropriate and takes its regulatory and fiduciary responsibilities seriously. Ofgem has in place a comprehensive set of obligations and mechanisms to manage financial resilience and dividend distribution, which include financial implications if network companies exceed notional gearing ratios included in each price control. NGT's gearing has been maintained at levels below the 60% notional amount set for the regulated business in the RIIO-2 price control.

2) What are stakeholder's views on the policy options outlined and the associated benefits and risks associated with each option? Are these areas where the policy options outlined could be optimised?

3) Should any other policy options be considered?

The following answer is in response to Questions 2 and 3. It is NGT's view that the indexation mechanisms that have been an integral part the RIIO framework have operated effectively. We do not support reviewing an isolated mechanism as this forms part of the broader regulatory framework and financial package and to do would fundamentally alter the balance of risk within the economic model.

We expect the financial framework will be a key component in the assessment of the next regulatory price control and particularly given the different proposed funding archetypes, we anticipate a need to consider a range of mechanisms as part of a holistic review to ensure companies are financeable.

For mechanisms that have been highlighted that are considered changes to the current framework (Options 2, 4 and 5), we believe these options would not pass Ofgem's evaluation criteria associated with regulatory stability and predictability, especially as this would be effectively either taking within period or retrospective action over the impact of two price control periods spanning 13 years. Our answer to Question 6, provides a more detailed rationale for this position.

4) Should the impact be assessed and policy options applied on a notional or actual company basis?

Demonstrating that the notional company is sufficiently financeable is a central theme of the RIIO framework and there is an inherent duty of the regulator to ensure this. Starting with an assessment of the matter at that level is therefore appropriate and allows comparison between network companies.

However, the reality of the situation each network company faces in respect of actual financing structures should also be taken into account, hence NGT's reference to the actual delta between RPI and CPI and actual cost of debt in Question 1.

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

The principles that Ofgem has applied in assessing this matter (Financial Resilience, Symmetry and Managing the pace of implementation) appear appropriate.

In particular, we support the notion that this matter should be assessed in the round and be symmetrical i.e. taking into account the lower than forecast RAV indexation that NGT and most other Licensees party to RIIO-1 suffered. We note that a similar consultation was not proposed during RIIO-1.

Managing the pace of implementation is also extremely important given the impact any action could have on the price control determinations network companies accepted in RIIO-2 and the respective financing strategies. We summarised NGT's (and indeed Ofgem's and the CMA's) view on the impact of retrospective action in the introduction to this letter and would note that a significant proportion of NGT's debt agreements run into the 2030's and would be time consuming and expensive to unwind should adjustments be required.

6) Do the proposed evaluation criteria comprehensively consider the consumer interest in this issue? Are these modification or additional criteria that stakeholders would suggest?

The evaluation criteria proposed by Ofgem (Protecting consumer interest, ensuring prices are fair for the consumer and are efficient, Regulatory stability and predictability and Price control legitimacy) appear appropriate.

As emphasised elsewhere in our response, protecting the credibility and stability of the regulatory framework in the UK is absolutely key to attracting the investment required to facilitate Net Zero. We do note that the consortium led by Macquarie that acquired 60% of NGT in January 2023 had an option to acquire the remaining 40% by end of July 2023. Only 20% has been taken up utilising this option window and an extension of the option window for the remaining share has been agreed to the end of December 2024.

Amending or over-riding the RIIO framework mid-way through a price control will undermine confidence in regulation in the UK and a subsequent increase in the cost of capital for network firms when the UK needs to attract record investment to facilitate Net Zero.

During RIIO-1, Ofgem elected not to reopen the price control during its mid-period review noting that *“it would undermine the benefits of the eight-year price control and also damage regulatory confidence. Any damage to regulatory confidence would increase the cost of finance, which would increase consumers’ bills in the future. For example, a 10 to 50 basis point increase in the cost of capital across the three RIIO sectors for an eight-year regulatory period could increase costs to consumers by £390m to £1.9bn. We think this impact would outweigh any short-term gains to consumers by clawing back money from areas beyond our proposed scope.”*² Ofgem then reinforce this further in the RIIO-ED1 mid-period review decision where they state with reference to their Impact Assessment of reopening the price control as *“an increase in the cost of equity of 0.5% (50 basis points) or in the cost of capital of 0.2% (20 basis points). Evidence from available academic literature and other regulatory decisions, both in the UK and elsewhere, suggests that increases of such magnitude are not unlikely.”*³

NGT also notes the parallels with the findings of the Competition Commission (“CC”) in respect of Phoenix Natural Gas’s appeal in 2012 against the actions of the Utility Regulator for Northern Ireland in respect of Phoenix’s 2012 and 2013 price control. The CC concluded in that case that the Utility Regulator’s proposed retrospective adjustment to Phoenix’s RAV, which was not consistent with previously agreed principles, was not justified and risked damaging confidence in the regulatory system. This was deemed the case despite the short-term impact on consumer bills as the decision was guided by the long-term interests of customers, as such actions would deter investment in the network from which they would benefit and increase Phoenix’s future financing costs, which would in turn be reflected in customer bills⁴.

It is NGT’s view that these factors are just as valid at this stage of RIIO-2, if not more so given conditions in capital markets at present.

7) Are these any further information or factors which should be considered as we review this issue?

The information provided by the Energy Network Association response to the Call for Input and the Frontier Economics report ‘Comments on Ofgem’s call for input on the effect of high inflation’ dated 21 September 2023, should be taken into consideration in our response, noting we have not sought to duplicate elements of those responses.

Appendices

1) Inputs to CPI-RPI wedge and actual cost of debt calculations

² Decision on a mid-period review for RIIO-1 and GD1 (12 May 2016), para. 2.6. Repeated in para. 1.17

³ Decision on a mid-period review for RIIO-ED1 (20 April 2018), para. 3.22

⁴ Competition Commission provisional ruling (3 August 2012) and final determination (19 December 2012) on Northern Ireland price control