

UK Power Networks' detailed comments on the Call for Input (CFI)

These comments should be read in conjunction with the Frontier Economics report "Comment on Ofgem's Call For Input on the effect of high inflation, 25 September 2023".

1. Have we characterised the issue accurately?

Ofgem's characterisation is broadly correct in that due to the design of the cost of debt mechanism, including the assumed split between fixed rate and index linked debt, the notional company will outperform the cost of debt allowance when outturn inflation is above the long run inflation assumption and vice versa when it is below it.

However, it has hitherto been accepted by Ofgem that there may be a difference between outturn inflation and assumed long run inflation and that network companies were exposed to this inflation risk. In the RIIO-GD1/T1 strategy document Ofgem 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."*¹

Companies have managed this risk through their choice of financing structure which is, as Ofgem's accepts, a management choice. We would note that over the RIIO-GD1/T1 period, the gas distribution and transmission sectors significantly underperformed their cost of debt allowances and Ofgem did not see a rationale to intervene when developing the RIIO-2 framework. Ofgem also states that if outturn inflation had been significantly below the long run inflation assumption it would have had to intervene. This was not the case for the RIIO-GD1/T1 period and even if Ofgem did decide to intervene it is likely that any intervention would have been done on an NPV neutral basis over the longer term.

2. Have we adopted an appropriate approach to the quantitative assessment?

We broadly agree with Ofgem's modelling approach. However, as Ofgem acknowledges, the future track of inflation remains uncertain and as such the actual impact of this issue remains uncertain and will do for some time. However, regardless of the modelling assumptions chosen, the impact of the issue on domestic customer bills is between £1.50 and £5.10 per year on a dual fuel bill.² The impact is small in the context of the size of network Regulatory Asset Values (RAVs) and the scale of future needed investment.

As noted in the Frontier report³ 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. Consequently, network companies have 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 to network companies.

¹ Ofgem, RIIO-T1/GD1 Strategy Decision, March 2011, paragraph 3.55

² Ofgem, Call For Input – Impact of high inflation on the network price control operation, August 2023, page 5.

³ Frontier Economics, Comment on Ofgem's Call For Input on the effect of high inflation, 25 September 2023, Annex B.3

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?

The indexation of the RAV has been a fundamental building block of the regulatory framework for energy networks since privatisation. The key benefit of this approach is that it ensures that historic investments are worth the same in real terms, irrespective of what happens to inflation. To ensure that investors are only compensated once for inflation the allowed rate of return is specified in real terms. Using a real (as opposed to nominal) WACC means investors are only compensated for inflation once, through the indexation of RAV to CPI-H.

This stable, predictable and transparent regulatory regime has delivered significant benefits for customers. It has helped keep the cost of capital low, whilst facilitating significant network investment and delivered excellent service delivery outcomes. As an example of the latter, the electricity distribution sector has delivered on average 90% customer satisfaction in 2022/23. UK Power Networks has delivered 94% customer satisfaction in 2022/23, placing it first in the sector. Furthermore, based on the latest Regulatory Financial Performance Reports the level of gearing in the electricity distribution sector, was below Ofgem's notional company assumption of 60%. Given this set of outcomes, we consider that the existing arrangements have delivered benefits to both investors and consumers. For investors, the inflation protection provided by RAV indexation has been a key underpinning of understanding of the risks associated with investing in network assets, and business decisions will have been taken over decades based on this long-standing indexation treatment.

Ofgem's CFI sets out initial thoughts on the set of interventions that could be made to address the "leverage effect". They are:

1. No policy action in relation to the leverage effect (i.e. retain the existing arrangements);
2. Making changes to dividend distribution policy around reporting and transparency;
3. Changes to future price control design (four sub options are presented), that Ofgem considers may have the potential to reduce or remove the leverage effect;
4. 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 leverage effect; and
5. Voluntary submissions by licensees to share any benefits.

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

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

As we stated in our response to the RIIO-ED2 Draft Determination, any change to the existing framework should be supported by a detailed and robust impact assessment. The bar to change the existing price control framework should be high and based on the points above we believe that there is a strong rationale for no change i.e. Option 1 (Do nothing).

We believe that any retrospective reopening of previous price controls or in period adjustments of current price controls would be extremely detrimental to customers' interests. 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. We believe this is what Ofgem is seeking to do with the Call for Input. However, any retrospective action would be contrary to regulatory best practice, would undermine investor confidence in regulatory stability and would have significant adverse effects. This is particularly relevant given the scale of investment that will be required to support the delivery of the UK Government's 2050 Net Zero target.

As the Frontier report⁴ highlights, retrospective reopening of a previous price control will damage investor confidence in the regulatory regime because:

- As an investor, you will now know that there is a risk your returns will be censored going forward if they are deemed "too high." This will inevitably increase the perception and reality of regulatory and political risk and will increase the cost of capital.
- It will also weaken the confidence of investors in the wider commercial framework. Going forward, the company would now have to factor into all of its future decisions the risk that if some improvement they make turns out to be "too good," then the rewards of that may also be confiscated, whether in part or in full. Management teams would now have to "risk adjust" their business cases and this will inevitably limit their appetite for such investment and limit the speed with which innovations are identified, pursued and rolled out.

Furthermore, the following key principles in respect of regulatory predictability were set out by the Department of Business, Innovation & Skills (BIS) in 2011: ⁵

- "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."

There is regulatory precedent for no retrospective adjustments to price controls. As highlighted in the Frontier report the Competition Commission (CC) quashed the Utility Regulator for Northern Ireland (UR) proposal to retrospectively reduce the Total Regulatory Value of Phoenix Gas⁶. The CC's rationale was the proposed retrospective reduction would create a perception of regulatory instability thereby deterring and/or increasing the cost of funding for the sector which in turn could impact the delivery of the required investment in the sector.

Ofgem has also recognised that 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.

As stated in the Frontier report⁷ in RII0-1 Ofgem decided to set the duration of its price controls to be eight years, whereas almost all energy network price controls before that had a duration of five years. While Ofgem noted there are a number of benefits to operating a longer price control (e.g. networks will be able to carry out longer term planning), Ofgem was also

⁴ Frontier Economics, Comment on Ofgem's Call For Input on the effect of high inflation, 25 September 2023, Section 2.2

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

⁶ Frontier Economics, Comment on Ofgem's Call For Input on the effect of high inflation, 25 September 2023, Section 2.3 and Annex A

⁷ Frontier Economics, Comment on Ofgem's Call For Input on the effect of high inflation, 25 September 2023, Section 2.3 and Annex A

cognisant that a long period without review brought with it some new risks e.g. that circumstances might change more substantially over a longer period, and that this might render aspects of the price control no longer fit for purpose.

In order to address this concern, Ofgem decided to put in place a Mid Period Review (MPR) to allow it to revisit some aspects of its decision. However, Ofgem was clear from the outset that the scope of the MPR should not de-facto, slip towards a full re-examination of all aspects of the price control. Consequently, Ofgem committed to a limited MPR, and also noted the need for a clear set of rules to be created to guide its operation. In summary, the MPR rules clearly states that the MPR will only cover new outputs Ofgem introduced at RIIO-1, and that Ofgem **would not make retrospective adjustments** [emphasis added] as part of the MPR process.

This principle is not new. For example, one of Ofgem's "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." ⁸

Furthermore, 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." ⁹

"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" ¹⁰

"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." ¹¹

"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." ¹²

"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

⁸ Ofgem, Regulating energy networks for the future: RPI-X@20 Principles, Process and Issues, 27 February 2009, para 2.8

⁹ Bernstein, UK Utilities: Our thoughts on Ofgem's call for input on inflation adjustments on debt, 2 August 2023

¹⁰ JP Morgan reaction to Ofgem's Call For Input.

¹¹ Investec, Ofgem looking at high inflation, 1 August 2023

¹² Moody's, Ofgem outlines possible changes following high inflation, 3 August 2023, page 1.

investment is required, especially by the electricity networks, to facilitate decarbonisation objectives.”¹³

The extracts above demonstrate that 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. We believe any decision by Ofgem to pursue retrospective claw back would undermine investor confidence in regulatory stability, raise the cost of capital and hence would not be in customers’ interests. This must be avoided by formally ruling out the potential for retrospective action.

In addition, we believe that voluntary contributions are de-facto retrospective adjustments and would suffer from the same issues as retrospective reopening of previous or current price controls.

We believe that if it can be demonstrated that it is in customers’ interests to change the specific price control treatment of these events then it should be considered as part of the current RIIO-3 price control framework development. This would allow Ofgem to appropriately consider how any change, if it was determined to be necessary, would interact with the other elements of the price control framework. This is essential to ensure that there are no unintended consequences which would be detrimental to current and future customers’ interests overall.

In the CFI, Ofgem has not set out a detailed description of the mechanics of the forward looking policy options that it has identified. It is clear that a number of the proposed mechanisms could have significant impacts on customer bills, reduce financial resilience in the sector and/or change fundamental regulatory building blocks. For example, a move to a nominal cost of debt allowance would, all other things being equal, increase customer bills in the short to medium term and mean that the RAV is no longer fully indexed to inflation. This would mean that the value of past investments would no longer be fully inflation protected. This may change investor’s view of the attractiveness of the sector to deploy capital.

Similarly, the option to use a forecast of inflation to set the cost of debt, rather than an appropriate forward looking long run inflation index, could result in negative real cost of debt allowances which would cause significant financeability issues for companies. As Ofgem notes a version of this approach was implemented by UR for the gas distribution companies in Northern Ireland. However, we also note that Moody’s¹⁴ raised significant concerns with the impact of this approach on financeability of the gas distribution companies. Furthermore, the choice of a different long run inflation assumption, to deflate the cost of debt, is highly sensitive to the choice of that assumption. Similar to the use of forecast short run inflation if inappropriately chosen it will have a significant negative impact on financial resilience.

This illustrates why it is vital that Ofgem only consider changes to the current inflation indexation approach alongside its development of the RIIO-3 price control framework given the interlinkages between different elements.

Notwithstanding the current lack of detail, and taking into account the issues highlighted above, the table below sets out an initial qualitative high analysis of the four forward looking options presented by Ofgem to address the impact of unusual inflation, based on our current

¹³ Moody’s, Ofgem outlines possible changes following high inflation, 3 August 2023, page 4.

¹⁴ In respect of this change in arrangements by UR, Moody’s commented “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.” See Moody’s (2023) Phoenix Natural Gas Limited, Update to credit analysis following final determination.

understanding of the options. We have looked at these options based on four specific criteria:

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

Our initial view is that an inflation adjustment mechanism, appropriately constructed, may be the best option to address this issue. The mechanism would be in principle be similar to existing RII0-2 operational returns adjustment mechanism in that it:

- Only operates once pre-determined thresholds are exceeded e.g. average outturn inflation over the price control period differs from the long run inflation assumption by a defined percentage. Similar to the operational RAM the thresholds should be set at a level that the mechanism would only operate in unusual circumstances i.e. the mechanism is a backstop;
- Is symmetrical;
- Is trued up at the end of price control period, minimising in period impacts on revenue and hence financial resilience; and
- Does not alter the fundamental underlying mechanics of the successful existing price control framework e.g. RAV indexation.
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Option	Effectiveness	Impact on Financial resilience	Impact on customer bills	Continuity in the fundamental regulatory model
Forecast short run inflation with end of period true up	●	●	●	●
Nominal fixed rate debt	●	●	●	●
Deflating by another long run assumption	●	●	●	●
Inflation adjustment mechanism	●	●	●	●

It is important that this mechanism is separate to the current operational RAM to preserve the latter's incentive properties and also only addresses inflation impacts i.e. the incentive to issue debt efficiently is maintained.

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

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. These are detailed in Appendix 1 of the Energy Network Association's response to the CFI.

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

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

4. Should any other policy options be considered?

At this stage of the RIIO-3 process we have not identified any additional policy options. However, the current list of options should not be considered as final, as additional options may be identified as part of the detailed RIIO-3 price control framework development.

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

In general the proposed principles appear appropriate. However, with respect to financial resilience it is important that this is considered over the longer term not just the RIIO-3 price control period.

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?

The proposed criteria do not include ensuring the financial viability of network companies over the long run. We believe it is vital to customers' interests that impact of any policy choice does not detrimentally impact financial resilience of network companies. It is also unclear how the principles for policy design and criteria for evaluating policy options interact. It would be helpful if Ofgem could provide greater clarity on this should this work be taken forward.

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

We have not identified any other factors which should be considered. However, similar to our answer to Question 4, additional factors will no doubt be identified as part of the detailed RIIO-3 price control framework development.