



SGN
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Call For Input - Impact of High Inflation on the Network Price Control Operation

SGN Response

26/09/2023



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By email to: RegFinance@ofgem.gov.uk

26th September 2023

Dear Regulatory Finance Team,

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

Thank you for the opportunity to respond to your above consultation.

In preparing our response we have worked closely with the other networks through the ENA Finance Working Group. We fully support the Energy Network Association response and the response below is intended to emphasise specific points. We are also submitting a report that the ENA has commissioned by Frontier Economics entitled "Comment on Ofgem's Call For Input on the Effect of High Inflation" which supplements this response.

1. Context of the review

Ofgem's CFI looks at the real cost of debt allowance and indexation of the Regulatory Asset Value (RAV) by inflation, which are key fundamental building blocks of regulatory policy since privatisation. We believe this stable regulatory regime has benefitted both investors and consumers. Equity investors in networks have been exposed to the difference between ex ante assumptions and actual inflation during this time (the 'leverage effect').


Whilst we recognise the high level of inflation which customers and businesses are currently facing that has prompted this review, we also think it is vital that the conclusions from this review recognise:

- the importance of inflation indexation to the price control framework
- the significant cost to customers that would arise if retrospective action were implemented or even considered
- the risks associated with changes to a long-established price control framework

2. Estimating the Quantum

Whilst we agree with Ofgem that recent inflation has been higher than was anticipated when the RIIO-GD2 price control was set, it should also be noted that for RIIO-GD1, SGN experienced lower effective returns to equity holders because of the lower-than-expected outturn inflation. Consequently, the difference between expected and outturn inflation over RIIO-GD1 and RIIO-GD2 is small in terms of customer bill impact.

The precise quantum of the leverage effect is very sensitive to the wide range of inflation forecasts currently available and the time period of the assessment. Also, Ofgem's modelling fails to take into account the impact on SGN of the differences between RPI / CPI and CPI / CPIH that have adversely deviated from assumptions made when the cost of debt allowance was set, partially offsetting the leverage effect. Regardless of these sensitivities,



we believe the impact on consumers remains small as the impact of the leverage effect arises in the RAV and hence the effect on revenues and bills will arise over a 45-year period.

3. Policy Options Considered:

Ofgem set out 5 options:

1. No policy action
2. Changes to Distribution policy around reporting and transparency
3. Changes to future price control design (four sub options presented) in relation to the cost of debt mechanism
4. Retrospective out/under-performance true-up at end of RIIO-2
5. Voluntary submissions by licensees on how benefits of additional RAV growth could be shared with consumers

The rest of section looks at the 5 options in more detail (not necessarily in the order Ofgem have set out).

3.1 No retrospective changes should be made to the current or historical price controls

Investors and rating agencies currently have confidence in the sector's regulatory stability and predictability. This is of key importance given the fact that in order to meet the government's net zero and energy security targets, Networks will need to secure very significant additional investment, and confidence in the regulatory regime is central to securing that investment over substantial time periods.

It is established regulatory practice for changes to the regulatory framework to be well signalled in advance, thoroughly consulted on, and only applied to future price controls. The consistency and integrity of the regulatory regime helps ensure our sector remains attractive to investment, particularly in the face of increasing international competition for capital. Any retrospective action would unsettle markets to the detriment of customers, be contrary to regulatory best practice, would undermine investor confidence in regulatory stability and predictability and result in increased cost of capital in the longer term, and significantly blunt incentives. These would be hugely costly to customers and therefore not in consumer interest, and must be avoided by formally dismissing the potential for retrospective action (*Option 4*).

It would also be 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 use of voluntary returns reduces the transparency through which regulatory settlements are arrived at and distorts the customer outcomes between networks.

The expectation of voluntary contributions is akin to retrospective action and would have the same detrimental impact on investor confidence and customer interests (*Option 5*).


Frontier Economics explores the highly damaging effects of retrospective action for customers in Section 2 of its report, which also highlights how regulatory precedent from the CMA and Ofgem demonstrates a strong desire in the past to avoid retrospective intervention and the rationale for that approach.

3.2 Dividend policy is robust and proportionate

Regarding Option 2, we believe Ofgem already has a comprehensive suite of obligations and mechanisms in place regarding dividends and their reporting via the licence and the Regulatory Performance Reporting requirements. SGN takes these obligations very seriously.

3.3 Potential changes to future price controls

In relation to Option 3, real cost of debt allowances and inflation indexation are fundamental components of the regulatory framework that have underpinned investor confidence. Any change to future price controls must only be considered in the context of the design of the wider future price control package and considerable work is required to establish whether any changes would improve on the current arrangements



(Option 1). Any changes to the future price control framework must be robustly tested, and stakeholders fully consulted to ensure that they do not create un-intended consequences that have adverse effects for customers. For example, several of the proposed options would seem to have significant implications for other hugely important aspects of the framework such as;

- customer bill profiles – including inter-generational differences and stability of network charges
- willingness of investors to deploy capital in GB energy networks
- financeability assessment methodology
- allowances for index-linked proportion of debt
- the basis of the cost of capital
- the operation of incentives and investment appraisal
- incentive properties and incentive strength

The options put forward by Ofgem are described at only a very high level and whilst they provide a starting point, given the complexity of the topic there needs to be much more detail before we can assess how they compare with existing arrangements.

We will work with Ofgem to support this work as part of the process to establish the framework for the next network price controls.

Frontier Economics comment on these options further in Section 3.2 of its report.

Conclusion

To conclude, SGN reject options 4 and 5 of Ofgem's proposed policy on the grounds that retrospective action would not be in consumer interests as it would fundamentally damage investor confidence at a time when the sector needs to attract significant long-term investment, and ultimately lead to higher costs through increased cost of capital. Regarding dividend policy (Option 2), we take transparency very seriously and believe Ofgem already has a robust set of obligations and mechanisms for dividends and reporting. Finally, we are happy to work with Ofgem to explore further the potential new mechanisms under option 3, however, given the high-level detail set out in this CFI, considerable work is required to establish whether any changes to the existing mechanisms could be made in the context of the wider price control package that would improve on the current arrangements (i.e. improves on option 1).

Should you require any further information with regards to our response then please do not hesitate to contact me at David.Handley@SGN.co.uk

Yours faithfully,



David Handley
Director of Strategy and Regulation
SGN



Call for Input Questions

1. Have we characterised the issue accurately?

Ofgem's CFI looks at the real cost of debt allowance and indexation of the Regulatory Asset Value (RAV) by inflation, which are key fundamental building blocks of regulatory policy since privatisation. We believe this stable regulatory regime has benefitted both investors and consumers. Equity investors in networks have been exposed to the difference between ex ante assumptions and actual inflation during this time (the 'leverage effect').

Whilst we recognise the high level of inflation which customers and businesses are currently facing that has prompted this review, we also think it is vital that the conclusions from this review recognise:

- the importance of inflation indexation to the price control framework
- the significant cost to customers that would arise if retrospective action were implemented or even considered
- the risks associated with any changes to a long-established price control framework

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.

As set out above in our response to question 1, recent inflation has been higher than was anticipated when the RIIO-GD2 price control was set. However, for RIIO-GD1, SGN experienced lower effective returns to equity holders because of the lower-than-expected outturn inflation. Consequently, the difference between expected and outturn inflation over RIIO-GD1 and RIIO-GD2 is small in terms of customer bill impact.

The precise quantum of the leverage effect is sensitive to the wide range of inflation forecasts currently available and the time period of the assessment. Also, Ofgem's modelling fails to take into account the impact on SGN of the differences between RPI / CPI and CPI / CPIH that have adversely deviated from assumptions made when the cost of debt allowance was set, partially offsetting the leverage effect. Regardless of these sensitivities, we believe the impact on consumers remains small as the impact of the leverage effect arises in the RAV and hence the effect on revenues and bills will arise over a 45-year period.

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.

We have set out in section 3.1 of our covering note why any retrospective action would unsettle markets, be contrary to regulatory best practice, undermine investor confidence in regulatory stability and predictability, result in increased cost of capital in the longer term and significantly blunt incentive properties of the price control. All these factors would be detrimental to consumers. Also, regulatory stability and predictability is of key importance given the fact that in order to meet the government's net zero and energy security targets, Networks will need to secure very significant additional investment, and confidence in the regulatory regime is central to securing that investment over substantial time periods.

We believe Ofgem already has a comprehensive suite of obligations and mechanisms in place regarding dividends and their reporting via the licence and the Regulatory Performance Reporting requirements. SGN takes these obligations very seriously (option 2).

We are happy to work with Ofgem to explore further the potential new mechanisms under option 3, however, given the high-level nature of the options set out in this CFI, considerable work is required to establish whether any changes to the existing mechanisms could be made in the context of the wider price control package that would improve on the current arrangements (option 1). Section 3.2 of the Frontier report expands on this point further.



4. Should any other policy options be considered?

Regarding option 3, as set out above, there is not enough detail to comment on whether the sub options are exhaustive. As we work through these with Ofgem and other key stakeholders, and assess the interactions with the wider price control framework, other sub options may come to light.

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

Whilst we recognise these principles as adding value, we also recognise that other principles could be considered, such as those set out by the National Audit Office in 'Principles of Effective Regulation'¹.

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?

Ofgem's evaluation criteria is very broad and this breadth provides scope for multiple interpretations of how that evaluation criteria can be delivered. In our covering note we have set out some more specific criteria we believe is important (see section 3.3). It is important that the development of policy against these criteria is an iterative process where policy developments are tested through consultation and in dialogue.

We have also clearly set out in section 3.1 of our covering note that we believe retrospective action is not consistent with Ofgem's evaluation criteria for regulatory stability and predictability, and why this would not be in consumer interest.

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

We have provided a detailed response through the ENA that has been supported through independent analysis carried out by Frontier.

¹ <https://www.nao.org.uk/wp-content/uploads/2021/05/Principles-of-effective-regulation-SOff-interactive-accessible.pdf>