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

Dear Rebecca

We welcome the opportunity to respond to this Call for Input (CFI) and the objective and structured approach taken in the published document, on what is a complex and important issue that merits consideration.

We are all aligned on the imperative of maintaining the reputation of the UK as an attractive investment destination, given the significant increases required in low carbon infrastructure in the coming years. Ultimately, there is a strong consumer interest in ensuring this investment happens in the required timeframe and in an efficient manner.

The current treatment of inflation is a fundamental cornerstone of the price control framework and the record investment in low carbon infrastructure over the last thirty years, both networks and generation, is a result of a predictable and stable regulatory regime which has also enabled a low cost of capital for the sector.

We welcome the explicit reference to ensuring regulatory stability and predictability as one of the key evaluation criteria set out in the CFI. Reflecting this, we strongly counsel against any proposals to change the current or previous price controls. Regulators have consistently understood that retrospectively re-opening price controls would undermine investor confidence and have a significant and sustained impact on the cost of finance, innovation and efficiency for a prolonged time period. This would be seriously detrimental to the interests of consumers.

We also counsel against any policy action that could lead to further restrictions on the ability of networks to pay dividends. Any suggestion of restricting dividends risks worrying investors and discouraging them from further investment to the detriment of consumers. Ofgem has already implemented numerous reporting and licence obligations on networks that can ensure transparency over dividend policies and decisions.

We already report on our dividend policies and dividends declared and paid, and how they consider long-term financial sustainability, including delivery for customers and other stakeholder obligations, within our RFPR submissions. Despite the high inflation experienced in 2022/23 NGET maintained its dividend at the same level as 2021/22, allowing gearing to fall to help fund future investment requirements. NGED moderately increased the dividend. NGET and NGED will continue to act responsibly in the dividends they pay.

Without prejudice to our view that no action is needed, if following feedback from the call for input Ofgem considers that policy action is required, National Grid would be open to engage with Ofgem to understand how changes to future price control design might be developed. Our response offers some preliminary thoughts and considerations for each of the sub-options included within the CFI and an additional sub-option for consideration which we think might represent a better outcome for consumers.

If you have any questions on this response, please contact richard.allman@nationalgrid.com

Yours sincerely,

Ben Wilson
Chief Strategy and External Affairs Officer

Executive Summary

National Grid Group's operations in the UK include: National Grid Electricity Transmission (NGET), which owns the high voltage transmission system in England and Wales; National Grid Electricity Distribution (NGED), which owns and operates electricity distribution networks in the Midlands, the South West and Wales; National Grid Ventures (NGV), which owns and operates energy businesses in competitive markets, including sub-sea electricity interconnectors; and National Grid Electricity System Operator (NGESO), a legally separate business within National Grid Group which balances the supply and demand of electricity in real time across Great Britain.

This consultation response on behalf of National Grid Group represents the view of NGET and NGED only.

We welcome the opportunity to respond to the call for input. The current treatment of inflation is a fundamental cornerstone of the price control framework which has been reaffirmed by Ofgem on multiple occasions over the last decades eg. RPI-X@20 review and each of the sector price controls. Regulatory stability and predictability are key to maintaining the confidence of capital providers, which in turn helps to keep the cost of capital of the sector lower than it otherwise would be. Therefore any outcome from this work must not have any retrospective implications which would undermine investor confidence and therefore drive up costs for consumers.

In this context we take some comfort from the clarity provided in the call for input that it is only considering the cost of debt (COD) mechanism and, specifically, the 'leveraging effect' associated with the COD mechanism.

We do however note that Ofgem characterises the leverage effect as being inconsistent with Ofgem's policy intent. While we recognise recent levels of inflation have been significantly higher than expected, this characterisation is at odds with comments made by Ofgem when the current policy was reconfirmed for RIIO-1¹. It is clear that Ofgem understood at the time that networks were exposed to inflation risk. When inflation varies from expectation there is no real terms impact on the network costs charged to consumers. Instead, these inflation variations represent a transfer of value between debt and equity holders.

Networks have long understood the existence of the leverage effect and have adopted different financing strategies to mitigate it, with some choosing to issue higher proportions of index linked debt to reduce the exposure. These strategies have been entered into in good faith, based on longstanding regulatory arrangements, by companies that expected to be exposed to the risks and consequences of their financing choices. To unwind the long-standing regulatory arrangements now would negatively impact on the confidence of making such choices in the future, both in relation to financing strategy and all other areas across the regulatory construct.

Regulatory stability and predictability of the regulatory framework are vital if the energy sector is to attract the capital required for Net Zero. The costs and risks associated with taking policy action may well outweigh any potential benefits of making changes. And these need to be properly quantified before any such action is taken. If Ofgem cannot be confident that changes will improve the design of the price control, changes should not be made. National Grid is supportive of option 1 (no policy action) as the recent levels of high inflation are not the norm, and we do not believe that changing the principles and incentives in the current regulatory framework to tackle such unusual circumstances is good regulatory practice.

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

We do not believe there is any merit in option 2 (distribution policy reporting and transparency) or that it would be an effective way of tackling the alleged problem. Dividend decisions are complex and networks are already subject to numerous licence obligations and reporting requirements relevant to dividends. This option does not address the causes of the leverage effect and would make the sector less attractive to investors. This would be detrimental to the interests of consumers given the need to attract substantial capital for Net Zero.

Option 4 (out or underperformance true up) would involve retrospectively re-opening price controls. Ofgem recognises that re-opening price controls will have a significant and sustained impact on the cost of finance with a detrimental impact on consumers². The call for input contemplates not only reopening the current price control, but also reopening the previous RIIO-1 controls. Such action would have a devastating impact on regulatory stability and predictability making it very hard to attract the capital required to fund the scale of investment required for Net Zero. In addition, we consider that this approach would be contrary to the interests of consumers, given the potential implications for incentives to invest in energy networks at a critical time, and it is not clear that it would therefore be proportionate or targeted to where action is needed. A case for such action would need to be robust and evidenced and consider the range of unintended consequences.

Option 5 (voluntary submissions by licensees) could similarly be seen as a reopening of the price control if networks were expected to offer something akin to a partial true up, while also suffering the risk of inconsistent outcomes.

Without prejudice to our view that no action is needed, if following feedback from the call for input Ofgem considers that doing nothing is not an option, National Grid would be open to engage with Ofgem to understand how option 3 (changes to future price control design) might be developed. The CFI provides very little detail on the various sub options that could be considered under option 3, and we would need to understand these options in further detail to provide a more considered view. We think it is important that any choice between sub-options be based on a series of criteria. We therefore offer some preliminary thoughts on relevant criteria in our response to question 3, along with initial comments and considerations for each of the sub-options listed under option 3 of the call for input.

In the interest of being constructive, our response also includes an alternative sub-option that we believe would fully address the leverage effect in future price controls through a change to the inflation rate used to index the proportion of the RAV funded by fixed nominal rate debt. This option would address concerns identified with the leverage effect but without reducing the predictability and stability of charges, and without impacting near term consumer bills. We recognise that this option would require further thought and may be complex to introduce but would be open to discuss the pros and cons and practical implications of such a mechanism as part of setting the RIIO-3 price controls.

We welcome and agree with Ofgem's cognisance of the need to proceed carefully, particularly in the context of the need for increased levels of investment to facilitate the transition for Net Zero and the wider consumer interest and agree that this is a complex and sensitive issue that needs to proceed at the appropriate pace. In light of the importance of allowing sufficient time to carefully consider and evaluate such policy options, and also the need to consider them alongside the wider design of the next price control, if Ofgem is

² Page 9 of the Call for Input states the true up option "*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.*"

minded to explore future options further we would encourage Ofgem to do so via the Sector Specific Methodology Consultations for the next set of price controls.

Call for Input questions

Q1 - Have we characterised the issue accurately?

We agree with the technical explanation provided in appendix 1.

We do however note that on page 1 Ofgem characterises the leverage effect as being inconsistent with Ofgem's policy intent. This characterisation is at odds with comments made by Ofgem when the current policy was reconfirmed as part of setting the RIIO-1 controls. Ofgem understood networks faced inflation risks with the cost of debt index when they 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."*³ [emphasis added]

Ofgem was not only aware of the risks to equity returns caused by inflation, but also observed the following: *"Behind our cost of debt forecasts are assumptions about future inflation and its impact on the cost of embedded conventional debt. Inflation rates are uncertain and liable to depart from our forecast, but we noted in draft determinations that investors in the regulatory asset value (RAV), taking both debt and equity investors together, are fully protected from inflation risk."*⁴

It is clear from this that the policy was set in full knowledge that real equity returns would vary from expectation if inflation differed from the assumption used to set the allowed COD, and that Ofgem did not consider this to be a problem at the time. This may in large part be because when inflation varies from expectation there is no real-terms impact on consumers. Instead, there is a transfer of value between debt holders and equity holders.⁵

We also note that one of the grounds Ofgem refers to for considering intervention on this issue is a view that Ofgem may have been compelled to intervene on financeability grounds had there been a symmetrical shock below the long run inflation assumption. Such a need for intervention is extremely unlikely due to the impacts the leverage effect has on credit metrics. The Moody's interest cover metric would potentially see no impact at all. The S&P FFO to debt ratio would benefit from including a lower value for debt accretion in both the numerator and denominator of the calculation, causing the metric to improve. It is only the gearing metric that would see a significant negative impact and notional gearing levels are typically well within the thresholds considered appropriate for regulated networks. For this reason, a material negative shock would be highly unlikely to trigger a need for Ofgem intervention due to the leverage effect. Further, even if action was deemed necessary, based on its past approach, Ofgem has typically adopted net present value neutral solutions to financeability such that there is no impact on the balance of risk between consumers and investors.

Q2 - 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.

We agree with the decision to use notional capital structures for the purpose of the quantitative assessment as such an approach is consistent with the notional basis on which

³ Ofgem RIIO-T1/GD1 March 2011 Strategy Decision, paragraph 3.55

⁴ RIIO-ED1: Final determinations for the slow track electricity distribution companies – Overview, 28 November 2014, para 5.18

⁵ Frontier Economics, Comment on Ofgem's Call for Input on the Effect of High Inflation, para 63

the relevant key elements of price controls, including allowed returns and cost of debt, are set, but note that the actual impact experienced by companies will be determined by their actual financing structure, rather than notional.

We also agree with Ofgem's use and choice of discount rate in the assessment.

With regard to the length of evaluation period, we do not consider there to be any merit in going back prior to RIIO-1, or specifically, back to 1997. There is clarity on how the allowed cost of debt (COD) was set from RIIO-1 onwards but prior to that the assumptions are unclear and, in some cases, it looks like no explicit assumption was made for inflation. There is no basis on which to assume the Bank of England target for inflation was used to set COD⁶. Similarly, prior to RIIO-1, even the appeal regime for the energy sector operated differently, further showing that going back and revisiting one element of the pre-RIIO-1 price controls would be unreasonable and inappropriate.

Similarly, an assessment considering the RIIO-2 period only would be too short and would appear highly selective given that it would be choosing to ignore the RIIO-1 period which, for the electricity transmission and gas sectors, saw inflation at levels below the long run assumption used to set the cost of debt.

Ofgem's assessment should include the full RIIO-1 and RIIO-2 periods and we welcome the fact that the quantification presented by Ofgem uses this evaluation period. Doing so captures the recent period of high inflation for all sectors, as well as the low inflation experienced in the preceding years during RIIO-1.

While agreeing with the use of notional structures, the evaluation period, and discount rates, we do not fully agree with Ofgem's quantitative assessment. We disagree with Ofgem's decision to exclude consideration of CPI-CPIH basis risk.

Ofgem included an allowance for RPI-CPI basis risk for RIIO-2 but no such allowance was provided for CPI-CPIH basis risk. When the RIIO-2 controls were set Ofgem assumed CPIH would be the same as CPI and simply used a CPI forecast as a proxy for CPIH. As explained in the Sector Specific Methodology Consultation, "*We are not currently aware of any reliable market-driven forecast of long-term CPIH inflation, but CPI and CPIH have been relatively similar historically. Therefore, it could be assumed that CPIH expectations will be equivalent to CPI expectations and that the OBR forecast for CPI serves as a reasonable proxy for an assumption of long-term CPIH expectations.*"⁷ Assuming a problem away cannot be deemed equivalent to funding networks for the basis risk. The quantitative assessment should include the impact of the divergence between CPI and CPIH. Doing so would reduce the quantum of the financial impacts experienced to date quoted in the consultation.

We have also identified a formula error in Ofgem's model that overstates the reported value up to 2022/23 by £143m⁸.

Q3 - 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.

⁶ The approach to setting COD became more sophisticated over time from the earliest price controls through to the start of RIIO. COD was previously often set as the real risk-free rate plus an assumed margin. Judgement appeared to play a large part in setting these parameters, and it is not clear from the available public documents what specific inflation value, if any, was assumed or used.

⁷ RIIO-2 Sector Specific Methodology Annex: Finance, para 2.16

⁸ Cell E34 of the ET-GT-GD worksheet sums cells E23 to L23. It omits cells C23 and D23 in error.

We agree with the principles for policy design and implementation, namely financial resilience; policy symmetry; and managing the pace of implementation. The focus on an appropriate transition timeline is both welcome and necessary. Companies have developed financing strategies based on the current treatment of inflation and mechanism for setting the COD. These strategies could take considerable time and / or cost to be changed to reflect any material change in policy going forward.

We cover each of the 5 proposed policy actions below.

No policy action in relation to this issue

Taking no policy action is an appropriate response and one that we would support. The treatment of inflation is a long-standing cornerstone of the price control framework. The allocation of risk, legitimacy of the price control, and fairness of prices were not called into question when inflation was below the long run assumption used in setting the COD, and it would be detrimental to regulatory stability and predictability to take a different view just because inflation is now above the long run assumption.

Ofgem has consistently been of the view that financing decisions and strategies are for the networks to decide and that investors should bear the risks and rewards of those decisions. While the level of outturn inflation is beyond the control of networks, they are able to mitigate the impact on them of the leverage effect. Companies can choose how much index linked debt to raise and, in doing so, can choose to fully mitigate the risk by having 100% index linked debt, whether that be through raising index linked debt or synthetically using derivatives.

If Ofgem chooses to take policy action it will need to determine whether such action should be based on actual or notional finance structures. If Ofgem chooses to act based on notional structures, any change in policy is likely to create winners and losers relative to the status quo. On the other hand, if Ofgem chooses to take policy action based on actual finance structures, it will be straying into regulating the companies' choices of financial structure and undermining the long-standing policy of investors bearing the risks and rewards of financing decisions. This shows that any action will need to be subject to strict impact assessment and quantification of any collateral risk and unintended consequences of such actions.

Great care should be taken in the development of any changes in current policy. If Ofgem cannot be confident that changes will improve the design of the price control, changes should not be made as the potential negative impacts of getting it wrong could be worse for consumers given the need to ensure confidence in the investability of the sector and the regulatory framework remains.

Distribution policy reporting and transparency

Ofgem has already put in place requirements to explain dividend policies and dividends declared and paid, and how licensees consider long-term financial sustainability, including delivery for customers and other stakeholder obligations⁹. If Ofgem has concerns with the quality of disclosures for some networks the appropriate course of action is to address those concerns with the relevant networks, not to impose further obligations on all networks.

Ofgem are clear on page 3 of the letter – “*For the avoidance of doubt, inflation protection is considered a cornerstone of our price control framework, and this Call for Input only considers the CoD mechanism.*” [emphasis added]. Distribution policy reporting and transparency is not linked to the COD mechanism and policy action on distributions would be

⁹ See Energy Networks Association response – Ofgem Call for Input – Impact of high inflation on the network price control operation, September 2023, appendix 1, for a brief summary of relevant obligations

an indirect solution at best and an irrelevant intervention at worst. Distribution policy does not address the issue Ofgem is considering and the leverage effect would still exist.

Some of the possible enhancements to existing requirements suggest Ofgem is actively considering further restricting the circumstances under which networks are permitted to make distributions. Dividends are a critical part of the investor proposition for investors in regulated energy networks. If the risks to receiving dividends are increased such investors would either be unlikely to be prepared to invest further capital or would require a higher return to do so.

Decisions on dividends are complex. A company may choose to retain earnings to fund investment in the network, in full anticipation of being able to pay a dividend later when investment requirements are lower. It would be difficult to develop additional guidance or policies that allow for such inter temporal decisions. Additional restrictions appear to have negatively impacted investor confidence and willingness to invest in the water sector. Given the need to raise substantial capital to invest for net zero, it would be counterproductive and bad for consumers to make it harder and / or more expensive to raise the necessary finance.

Changes to future price control design

As set out above, we consider that no action is needed to address any leveraging effect as this is part and parcel of the design of the current regulatory framework. But in the spirit of being constructive, should Ofgem decide that there is sufficient evidence to justify intervention, the only appropriate policy action that should be pursued is via a change to future price control design. We are open minded to the possibility of such a change if it is proven that this will not negatively impact investor confidence and would be prepared to engage with Ofgem to explore options such as those mentioned in the open letter, and possibly others.

The precise mechanism will be important and insufficient detail is provided in the open letter to fully understand what might be involved with some of the options. Our comments are therefore based on our current interpretation of what the sub-options might entail.

We believe the following to be important in the development of possible changes:

- Any change should be implemented as part of the RIIO-3 price controls rather than set separately. The treatment of inflation is an integral part of the financial framework and it is appropriate to review the whole framework in the round rather than taking one part in isolation outside the price control setting process.
- Any change should consider the impact on the financeability of the networks, and the ability to raise the capital required for Net Zero
- Any change should be forward looking only, i.e. it should not include a claw back of all or part of the leverage effect from RIIO-1 or RIIO-2.
- The impact on the predictability and volatility of revenues and charges should be considered. Ofgem has previously taken steps (including setting charges 15 months in advance) to increase the predictability and stability of charges for the benefit of customers and consumers. Options that increase the volatility and unpredictability of the allowed return (and hence revenues) would undermine these measures and be bad for consumers.

Looking at the example options included within the call for input, we make the following observations:

- The use of annual true ups or short-term inflation forecasts is likely to undermine the predictability and stability of charges, and so be bad for consumers. Depending on the basis of the inflation forecast used, option 3(i) could see the use of volatile near-term inflation forecasts that generate volatile revenues and credit metrics, potentially increasing debt costs.

- Further it would be inappropriate either to use short term forecasts or to perform a true up based on outturn inflation, since it is long run inflation expectations that will be reflected in the nominal debt costs used by Ofgem to set the COD. Ofgem was very clear on this in the RIIO-2 Sector Specific Methodology Decision when it wrote “*we do not believe outturn inflation data is a good indicator of the long-term future inflation expectations that are embedded in the long-term debt constituents of the iBoxx indices used. **We continue to believe that a long-term estimate of inflation expectations is more appropriate for deflating an index based on long-term debt rates.***”¹⁰ [emphasis added].
- Providing for a nominal allowance for the COD (option 3(ii)) could be an effective policy change but is likely, all other things being equal, to increase revenues and consumer bills in the near term and reduce them longer term. How such a policy change fits with other aspects of the price control financial package would therefore be an important consideration.
- The use of an alternative long run inflation assumption (option 3(iii)) would not remove the inflation leverage effect caused by the short-run inflation perturbations that appear to have prompted the call for input. It can only reduce the effect at best and, even then, only if that forecast is more reliable than the one it replaces. An alternative measure of inflation could increase rather than reduce the leverage effect if the wrong forecast is chosen, unless it is accompanied with a true-up. We would therefore suggest that if this option is to be taken forward, it be accompanied with an end of period true-up. The methodology for setting any alternative long run assumption would need both to be a well-justified improvement to the existing approach and to be clearly documented to avoid increasing uncertainty and regulatory risk for investors, to the detriment of consumers.
- Options such as a Return Adjustment Mechanism (RAM) (option 3(iv)) could undermine incentives within the price control if high or low inflation triggers the RAM and dilutes the impact of incentives on returns. A separate RAM specific to the inflation leverage effect, calculated on a cumulative basis over the course of the price control (from RIIO-3 onwards), could avoid such unintended consequences. This option has the potential to reduce the leverage effect but would not remove it.

Another option not mentioned by Ofgem which could be explored would be to continue to set the COD in accordance with Ofgem’s current policy, but to change the inflation indexation for that portion of the RAV that is notionally funded by fixed rate debt, so this portion is indexed using the same long run inflation assumption that was used in setting the COD. Actual inflation would still be used for the inflation indexation for the proportions of the RAV that are notionally funded by equity and index linked debt. Similar to the nominal cost of debt solution in option 3(ii), such an approach could fully address the leverage effect for the notional company without reducing the predictability and stability of charges, but in this case without impacting on near term consumer bills. This option would require further thought and may be complex to introduce. Notwithstanding our view that there is not sufficient evidence to suggest that intervention is proportionate or needed, should Ofgem be minded to take some action to address the leverage effect in future price controls, we would be prepared to engage further with Ofgem on this alternative as part of the process of setting the next round of price controls.

Out or under performance true up

The regulatory framework is currently seen positively by rating agencies, for example Moody’s wrote “*The high hurdle placed on making fundamental changes to the principles of the well-*

¹⁰ RIIO-2 Sector Specific Methodology Decision – Finance, para 2.85

established regulatory framework in Great Britain supports our favourable view of the regime's stability and predictability.”¹¹

Stability and predictability of the regulatory framework are vital and secure two key benefits:

- They maintain the confidence of investors, reducing their perception of risk, resulting in a lower required return than would otherwise be the case; and
- They can stimulate improvements in efficiency by providing confidence that when investments (of money or resource) are made, the rewards of them will be shared in line with established and well understood regulatory arrangements.

To avoid being retrospective in nature, a change to the regulatory framework must be well signalled in advance, thoroughly consulted on, and must only apply going forwards.

The out or under performance true up option appears to involve making an adjustment (e.g. to RAV) at the end of the RIIO-2 price controls to adjust for licensees' actual out or underperformance over a defined evaluation period. This would be seen by investors and other stakeholders as retrospective action to change the price control mechanisms, returns and allocations of risks during RIIO-2 (and potentially RIIO-1) that were set ex-ante after the outturn for a particular risk has become known. Even if this change only took effect through an adjustment to the opening RAV for RIIO-3 – and so only affected revenues during RIIO-3 and beyond – it would be clearly seen by all parties as a retrospective change to a price control.

The importance of regulatory stability and predictability was recognised by Ofgem when it introduced the RIIO framework. In the “Handbook for implementing the RIIO model”, Ofgem set out that: *“Network company decisions will be influenced by their perceptions of the credibility of the regulatory framework. The RIIO model is designed to provide certainty and transparency about how the framework will work in the future. As part of this, **we will seek to avoid any retrospective/ex post adjustments to the package agreed in final proposals and licence modifications as this could undermine regulatory commitment.**”¹²* (emphasis added)

Ofgem then maintained this commitment in RIIO-1 when it 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.”¹³*

This was then reinforced further in the RIIO-ED1 mid-period review decision where it stated with reference to its 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.”^{14 15}*

¹¹ Moody's - Ofgem outlines possible changes following high inflation, 3 August 2023, page 1

¹² Ofgem, Handbook for implementing the RIIO model, 4 October 2010, page 29

¹³ Decision on a mid-period review for RIIO-T1 and GD1, (12 May 2016), para 2.6. Repeated in para 1.17.

¹⁴ Decision on a mid-period review for RIIO-ED1, (30 April 2018), para 3.22

¹⁵ Further coverage of the RIIO-1 mid period review precedent, and the Competition Commission determination of Phoenix Natural Gas' price control in 2012 can be found in the Frontier Economics Report – Comment on Ofgem's Call for Input on the Effect of High Inflation, section 2.3 and Annex A.

While the possibility of making changes to price control arrangements in recognition of the inflation leverage effect was raised during the RIIO-ED2 Draft Determinations, no such possibility was raised when the RIIO-T2 and GD2 controls were set.

The impacts presented above considered the scenario of reopening the live price control, i.e. changing the existing price control. These impacts would be higher if recalculated today given the growth in the RAV and scale of investment required for Net Zero, particularly across the electricity sector.

The true up option potentially envisages going even further and reopening not just the current price control but also the preceding, now closed, RIIO-1 price control. Investors can have no confidence in a regulatory environment where you can not only change the current rules but can potentially go back and change the rules and results of the past. Such a move would likely increase the cost of capital by significantly more than Ofgem's previous assessment.

It then follows that there is no acceptable common cut off point in the past from which to calculate a true up from. Based on Ofgem's quantitative assessment, clawing back the benefit from RIIO-2 only would appear highly discriminatory against the electricity transmission and gas sectors (as offsetting impacts in the opposite direction in these sectors during RIIO-T1/GD1 would then be ignored), whereas clawing back over both the RIIO-1 and RIIO-2 price controls is unthinkable in terms of the impact on regulatory predictability and stability, and investor confidence.

It is likely that the cost to consumers of reopening the current price control would exceed the value of any inflation leverage effect true up, particularly when it is considered that the impact on the cost of capital could well endure across multiple price controls. This appears to be acknowledged in the call for input (page 9) where Ofgem comment that option 4 *"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."*

The inflation leverage effect is a known risk. Different companies have adopted different financing strategies and chosen how much of the risk to mitigate through, for example, their choices on how much index linked debt to raise, be that actual index linked debt or through the use of derivatives. These strategies have been entered into in good faith, based on longstanding regulatory arrangements, and it would potentially take many years and substantial cost to change them.

Ofgem has specifically considered issues of regulatory stability regarding the COD before. As part of the RIIO-2 Sector Specific Methodology Decision Ofgem decided not to implement sharing of cost of debt performance. For example, at 2.35 Ofgem said *"It is also important to recognise that, because of the volume of embedded fixed rate and inflation linked debt in the sector which has long dated maturities, decisions that were made in previous price controls will impact debt performance in RIIO-2. Therefore, any introduction of sharing would risk imposing retrospective sharing of risk for decisions that were made expecting no sharing of this risk and/or return. This would represent a significant departure from our previous stance and, if introduced now, may raise questions over regulatory stability."*¹⁶ Ofgem specifically decided not to share COD performance for RIIO-2 and any decision to retrospectively change that decision by introducing a partial or full true up of the leverage effect would seriously damage confidence in the regulatory regime.

Importantly, the adverse impacts from undermining confidence in the regulatory regime would extend significantly beyond the cost of capital. Undermining regulatory predictability and

¹⁶ Ofgem – RIIO-2 Sector Specific Methodology Decision – Finance, 24 May 2019, para 2.35

stability could adversely affect service levels, investment, innovation, and efficiency in the short, medium and long term.

Moody's summarise their views on option 4 with the conclusion *"We believe the most radical option, for example by clawing back retrospective outperformance in RIIO-2, was included largely for completeness. Such a change would undermine investor confidence in the predictability and stability of the regulatory regime when significant investment is required, especially by the electricity networks, to facilitate decarbonisation objectives."*¹⁷

The predecessor of the CMA has also previously noted that, in line with normal regulatory practice, any revision of previous regulatory determinations should be *"well reasoned, properly signalled, subject to fair and effective consultation, clear and understood, and, normally, forward-looking"*.¹⁸

Voluntary submissions by licensees

As noted previously, we already report on our dividend policies and dividends declared and paid, and how they consider long-term financial sustainability, including delivery for customers and other stakeholder obligations, within our RFR submissions. Despite the high inflation experienced in 2022/23 NGET maintained its dividend at the same level as 2021/22, allowing gearing to fall to help fund future investment requirements. NGED moderately increased the dividend. NGET and NGED will continue to act responsibly in the dividends they pay.

Any suggestion that networks should return some or all of the results of the leverage effect amounts to the same thing as an outperformance true up and the negative consumer impacts described in relation to option 4 above would apply. While Ofgem would not be the party reopening the price control, the precedent of making it clear that Ofgem expected networks to make equivalent commitments can be expected to similarly impact on investor perceptions of regulatory risk.

Ofgem appears to consider a one-sided version of voluntary submissions. This would not be consistent with Ofgem's proposed principle for policy design of policy symmetry since it is implausible that Ofgem would accept, as part of a voluntary solution, the flexibility for an increase in networks' allowed revenues above what would they otherwise be if certain levels of inflation materialise.

We also note that while voluntary submissions could potentially address the impact the leverage effect has had, they would do nothing to actually remove the existence of the leverage effect. If Ofgem concludes that action is necessary in relation to the leverage effect then such action should be policy based, using a defined methodology, and be consistently applied.

Q4 - Should any other policy options be considered?

The five policy options included in the open letter are broad and varied. We do not believe other obvious policy options are missing or need to be considered. We have made suggestions, in our response to question 3, of an alternative that could be explored, if the need for intervention is established, as part of a change to future price control design.

This is a complex issue. There are a number of potential variants within some of the sub-options outlined by Ofgem, and it is not clear from the open letter how some of the options would work in practice. In addition, any of the options will require significant impact assessment and evidence, to fully understand their impact on the carefully balanced incentives set as part of the RIIO framework. Designing a new mechanism for future price

¹⁷ Moody's - Ofgem outlines possible changes following high inflation, 3 August 2023, page 4

¹⁸ Competition Commission, Phoenix Natural Gas price determination, Final determination, 28 November 2012, available [here](#)., para 32.

controls is not straightforward, and Ofgem would need to ensure that – as much as possible – unintended consequences were avoided, especially when considering interactions with other policy decisions in seeking to optimise the overall financial framework and achieving Net Zero targets. For this reason, any changes for future price controls should be developed through the wider process of developing the overall framework for the next round of price controls rather than on a stand-alone basis.

Q5 - Are the principles proposed for policy formulation complete and appropriate?

The principles proposed seem appropriate. However, we believe it would be helpful to be more explicit about considering what is in interests of consumers, particularly in the longer term. We cover this more in our response to the next question.

Q6 - 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 agree with the merits of the proposed evaluation criteria and think they do consider the consumer interest comprehensively. It is self-evident that criteria such as protecting consumers interests and ensuring prices are fair for the consumer and efficient are targeted at the consumer interest.

It is worth noting that regulatory stability and predictability is, first and foremost, an evaluation criterion that is essential to the protection of consumer interests, particularly in the medium to longer term. Consumers benefit from regulatory stability and predictability because they are key to maintaining the confidence of capital providers, which in turn is key to keeping the cost of capital of the sector low. Similarly there is a need to ensure the attractiveness of the UK as an investment destination is maintained. There is a need for significant new investment in energy infrastructure. The record investment in low carbon infrastructure over the last thirty years, both networks and generation, is a result of a predictable and stable regulatory regime.

The consumer interest would be considered even more comprehensively with the addition of a criterion considering impact on the volatility and predictability of charges. Ofgem has previously taken steps (including setting charges 15 months in advance) to increase the predictability and stability of charges for the benefit of customers and consumers. Options that increase the volatility and unpredictability of the allowed return (and hence revenues) would undermine these measures and be bad for consumers.

We also suggest a criterion be added associated with avoiding unintended consequences. This is critical and should form part of any impact assessment and the evidence base to justify intervention. Financing structures have always been for companies to choose in the expectation that they will be exposed to the consequences, good or bad, of those choices. Certain policy options could have the unintended consequence of changing this principle if they have the effect of more strongly incentivising one financial strategy over another, e.g. whether to more closely match the notional financing structure.

Finally, there is no reference to complexity or other difficulties in implementation amongst the evaluation criteria. Complexity can increase the risk of unintended consequences so these two considerations could be combined or reviewed separately.

Q7 - Is there any further information or are there other factors which should be considered?

We note that the call for input is specific to network price controls only. There are numerous other regulatory frameworks that Ofgem has jurisdiction over, but this consultation does not

consider whether policy action should be considered to change those frameworks. By way of example, OFTOs have substantial debt funding and the framework includes inflation indexation.

While we do not suggest Ofgem needs to consider these other frameworks, the fact that it has not done so indicates to us that Ofgem may agree that it would be unthinkable to re-open regulatory frameworks in such a way.