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Dear Regulatory Finance,

Response to Call for Input - Impact of high inflation on the network price control operation

I am writing to respond to the Call for Input on the impact of high inflation on the network price control operation which was published on 1 August 2023. We look forward to working collaboratively with you to establish if improvements can be made to the regulatory framework as part of future price controls. We have set out below our thoughts regarding the policy options proposed and importantly our concerns with respect to any policy option pertaining to a retrospective adjustment to existing or previous price control as these are not in the best interests of our customers.

We summarise below our response which should be considered in conjunction to the responses submitted by the Energy Networks Association ("ENA"); and report by Frontier Economics that was commissioned on behalf of ENA members.

We have fundamental concerns with Policy Option 4 which pertains to a retrospective adjustment to the price control.

We are supportive of improving future price control design if deemed appropriate. The sector has benefitted from stability of regulatory policy and revenue setting; it is well supported by credit markets who value the certainty that has supported significant investment and lower costs to consumers from an efficient cost of capital.

Policy option 4 would involve a retrospective true up to previously agreed price control(s) and would, if implemented, fundamentally impact investor confidence. The Frontier Economics report attached to this response summarises the risks to customers and investors of this policy option. We firmly agree that this would be highly credit negative in a period when the sector needs significant capital to deliver on providing safe and reliable networks to customers.

In Policy option 3, any amendment to the existing cost of debt mechanism must be demonstrably beneficial to consumers and support investor confidence to make long term capital investment. There is a high bar for making a change given the risk of unintended consequences.

There has been a long-standing approach to regulatory finance that relies on revenues being calculated on a notional company basis with actual capital structures and risk management being a decision for owners to opine on based on their risk appetite. Risk appetite relative to inflation has been a choice for shareholders, often managed through the use of inflation linked debt and derivatives. Capital structures have been put in place to support these risk management strategies into the long-term allocating risk across debt and equity holders.



Although there is limited detail on the policy options presented, some could be interpreted to be linked to actual company financing decisions. The cost of debt in actual company financial structures will be very different from a notional company, for example, due to timing of refinancing requirements. During RIIO-2, Ofgem acknowledged that our debt book requires exceptional adjustment due to the timing of separation from National Grid and associated refinancing. This item is material and important to keep front of mind when considering policy options. Significant costs were incurred to refinance our debt book in 2017 to the benefit of consumers. This up-front investment from current owners was made possible on the basis of a stable regulatory underpinning. Subsequent to the change of ownership, there has been a rapid increase in investment and improvements in customer performance. Any amendments should not disincentivise future investment of this nature.

Ofgem has not intervened in the counterfactual to date where inflation is below the long run average.

Networks have in the last 10 years often experienced inflation below the long run expectation as highlighted by Frontier Economics. As we agreed our RIIO-2 price control, we were further expecting low inflation or potentially deflation as the economy emerged from COVID. We highlighted this concern through the consultation process. As frameworks were not amended to take account of this risk to investors, networks (including Cadent) hedged downside inflation risk accordingly. Therefore, we do not believe it is appropriate to suggest that Ofgem would intervene (particularly on an NPV positive basis) in the counterfactual where inflation is below the long run estimate.

Dividends are an important component of incentivising investment. There are significant protections in place to ensure investors make responsible and transparent distributions.

We understand that dividends are sensitive and complex in nature for stakeholders to understand given the multiple elements which form part of their quantification and timing of their payment. We welcome Ofgem's improvements to reporting through the Regulatory Financial Performance Reporting ("RFPR") tables and we will continue to ensure our payments are highly transparent and visible through our Annual Report and Accounts.

We (along with the ENA) summarise in our responses the existing measures in place to provide transparency and protect consumers through the licence. We have provided additional detail in our RFPR published this September which demonstrates this commitment. We do not believe Ofgem requires new policy or powers to deliver on this ambition.

Alongside Ofgem's requirements under the licence, there are many other protections from inappropriate dividends through financing frameworks, tax incentives, corporate governance code and within the Companies Act.

We welcome Ofgem working collaboratively on the notional company financial modelling. This points to the Gas Sector being a relatively small component of the modelled impact as a result of the timing of transition to CPIH based price controls. The actual company performance has been significantly lower than a notional company.

Ofgem's assessment of the consumer impact of higher inflation is low (10p to 80p) for the notional companies in the Gas sector. This is due to the timing of moving to a CPIH based price control in early 2021 which creates a disparity across sectors.

Networks took long term decisions to use RPI inflation hedges that extend beyond 2021 resulting in a basis risk between RPI and CPIH. Care should be taken when considering the modelled outputs that stakeholders may not understand that actual companies are not in the same financial position as the "spreadsheet" modelled notional company outputs.

High inflation has been credit negative to Cadent as a consequence of rising and volatile input costs.

S&P in their recent rating assessment has pointed to high inflation and its impact on interest rates as the main driver of reducing headroom relative to its credit metric targets. At a time when there is limited flexibility in a price control around output delivery and under-funded totex expenditure compared to our business plans, we expect that the gas distribution sector will under-perform the allowed totex, partly

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driven by the significant inflationary impact on input costs not covered through regulatory allowances. Customers are partially protected from this as shareholders support the costs from their balance sheet, however, with limited flexibility in a price control to mitigate these risks, the issue highlighted in the Call for Input should be considered “in the round” with the broader risk assessment as part of a future price control design.

We note the consultation asks for ideas of what voluntary options networks might provide. This is something we already have taken account of in terms of the RIIO-2 business plan and the way we support the communities we serve. We want to be a company that will continue to lead the sector in its performance and strategic thinking. We voluntarily provide over 1% of profits per annum into the Cadent Foundation, equivalent to c. £5m p.a. to deliver on our force for good strategy which is by some way biggest contribution in the sector.

We believe the gas networks can best play its part in the energy transition if there is a whole system-based approach that puts the customer at the heart of the transition over time and that retains optionality as we go forward. Appetite for investment in the gas sector is becoming increasingly costly with a tougher external climate for inbound investors into the UK and gas sector.

Delivering on our Force for Good Strategy funded partially via investor commitment to the Cadent Foundation is a material and important voluntary contribution to customers, particularly those most impacted by the cost-of-living crisis.

A focus on significant corporate finance changes which may increase bills in the short term could disincentivise investment.

To deliver on our ambition requires significant investment in our infrastructure, stable regulation, and low-cost financing. Some of the policy options outlined in the Call for Input and recent discussion regarding further acceleration of RAV depreciation increase consumer bills in the short term. Ensuring the required investment can be financed efficiently and is affordable to customers should be a priority.

My team and the sector will shortly be working with you on setting a new price control. We look forward to working through the potential issues highlighted in the Call for Input to ensure consumer and investor interests are protected.

Yours sincerely,

Steve Fraser



Cadent response to Call for Input Questions

Question 1: Have we characterised the issue accurately?

The Call for Input considers a very complex subject that is central to the current framework. Given this complexity, it is important that stakeholders understand the issues and it is characterised appropriately. With this in mind, it is important to re-iterate that:

Ofgem expected that there would be variances between outturn inflation and actual inflation. Ofgem have not intervened in the counterfactual to date where inflation is below the long run average.

Networks have in the last 10 years often experienced inflation below the long run expectation as highlighted by Frontier Economics. As we agreed our RII0-2 price control, we were further expecting low inflation or potentially deflation as the economy emerged from COVID. We highlighted this concern through the consultation process. As policy was not amended to take account of this risk to investors, networks (including Cadent) hedged downside inflation risk accordingly. Therefore, we do not believe it is appropriate to suggest that Ofgem would intervene (particularly on an NPV positive basis) in the counterfactual where inflation is below the long run estimate.

The characterisation of a “leverage effect” needs careful attention to avoid any misunderstanding of the issue. The existing financing arrangements have supported low-cost debt financing, spreading costs fairly across generations under RAV based models. A price control is intended to have a leverage effect where networks receive a real cash return and the inflation of the RAV provides an asset base to borrow against and spread costs “equitably” across generations. This relies on investors to take the risk that over time the RAV will be recovered and continue to generate a “fair” return to compensate for these committed liabilities.

Networks make long term financing decisions based on an inflation risk management strategy that aligns to their risk appetite to inflation. Owners can impact the inflation risk that they are exposed to through hedging instruments such as inflation linked debt. When inflation is different than expected, there is a value transfer between the debt holders and the equity holders. We do not see any leverage here in the traditional sense of the word, and this characterisation of a leverage effect may be misleading to stakeholders. Care must be taken to ensure that Ofgem are not undermining regulatory stability and reducing the confidence of investors to put in place long term risk management strategies.

Inflation cuts across every aspect of our business from operations to financing. Importantly the investment programme where we have experienced increasingly challenging output requirements and unfunded input cost pressures relies on inflation based indexation. The focus on fixed rate debt funding risks characterising inflation as an asymmetric benefit to networks. S&P has noted high inflation as negative to credit metrics and commented that they expect inflation, combined with higher interest rates, to erode Cadent's headroom; demonstrating that high inflation and related interest rate variability poses risks to the financeability of networks. Further there is a time lag of recovery as returns from the higher RAV are generated over a period of time, whereas inflationary cost pressures have an immediate impact, thus creating a mismatch between cash inflows and outflows. These cash outflow impacts have a direct impact on metrics.

The modelled financials including bill impact are significantly lower for Cadent than the energy sector as a whole as a result of the timing of when the Gas Distribution networks moved to a CPIH based price control. **Characterisation of the issue as being the same across sectors could lead to an imbalanced policy response.** Any amendments will take time to implement and Ofgem should ensure sufficient time to robustly test any amendment.

The characterisation of the issue focuses on the notional company and there are many differences to actual company structures. Networks chose to protect themselves against inflation volatility by securing more inflation linked debt than the notional company faced with downside inflation risk. There was no response or additional support from Ofgem. Now with higher inflation, it is inconsistent that the sector is penalised or discouraged from putting in place inflation risk management strategies.



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

From a modelling perspective, **we welcomed Ofgem's engagement on the issue prior to release of the Call for Input.** We refer to the Frontier Economics report which provides further details.

We note that the modelling is highly sensitive to a number of assumptions, but the current assumptions within Ofgem's model implies **the impact on customer bills is relatively small from Cadent's perspective.** The modelling shows that the issue for Cadent is far less pronounced than for the wider sector who have remained on the RPI measure of inflation for a more extended period. Ofgem's analysis shows that the impact is limited to £0.10 to £0.80 per customer.

Actual company debt books are not comparable to the notional company which is used to develop the modelling.

Networks have in the last 10 years often experienced inflation below the long run expectation as highlighted by Frontier Economics. As we agreed our RIIO-2 price control, we were further expecting low inflation or potentially deflation as the economy emerged from COVID. We highlighted this concern through the consultation process. As policy was not amended to take account of this risk to investors, networks (including Cadent) hedged downside inflation risk accordingly by putting in more inflation linked debt than the notional company, reducing the modelled impact.

The Frontier Economics and ENA reports submitted separately provide further details.

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

We provide initial views below but caveat that with reference particularly to policy option 3, there is limited detail and as such we are not able to conclude until further detail and analysis occurs as part of a future price control in which it could operate. We welcome working with Ofgem as part of a price control process.

We are seriously concerned about Policy Option 4 which is in effect a retrospective true up in relation to the current or previous price controls. Both the ENA and Frontier Economics reports accompanying this note provide the full details and evidence supporting the potential adverse impact this could have on consumers and investor confidence. Given the quantum of future investment required, any action that could undermine investor confidence in UK utilities is serious. We are already seeing challenges to inbound investment decisions linked to the wider macro environment in the UK and sector specific issues.

Option 1 – No Policy option in relation to this issue

There is a high bar for making a change given the risk of unintended consequences.

We understand that Ofgem is seeking to reduce or eliminate the "leverage effect". This option would not eliminate this effect as it exists by design.

Historically, outturn CPIH inflation has closely followed the 2% Bank of England ("BoE") target since the BoE's independence in 1997 and the recent economic events are unprecedented and the probability of the circumstances that led to them (a global pandemic shortly followed by a war in Europe) being repeated are low.

It is very possible that the current period of very high inflation will not re-occur in the medium term with central banks demonstrating their willingness to take the steps necessary to reduce inflation.

Alternatives may introduce new unexpected consequences which could be detrimental to customers relative to the counterfactual of remaining with the existing mechanism.



Great care must be taken to ensure any options under consideration improve the framework in a way that is in customers' and investor interests; improving the design of the price control, reducing risk. If there is no clear-cut improvement in the mechanism following the detailed analysis of the alternatives, we would support Option 1 which has encouraged significant investment over a long-time horizon.

Option 2 – Distribution policy reporting and transparency

Dividends are an important component of the investment package and there are significant protections in place to ensure investors make responsible and transparent distributions.

Ofgem already has a comprehensive suite of obligations that support transparency and appropriate dividend policies. Networks take these obligations seriously and the ENA has summarised these in their report. These obligations combined with protections provided through financial structures, tax incentives relative to gearing, and existing Companies' Act / governance codes.

We understand that it can be difficult for stakeholders to understand the link between dividends and performance. We have reflected on disclosures provided within our Annual Report and Accounts and Regulatory Financial Performance Reporting to continue to improve transparency and understanding of these.

Given the existing protections in place, we do not believe that Ofgem needs additional powers to improve transparency, however, we will work with Ofgem to ensure comparability through existing reporting.

Importantly, dividend decisions require flexibility to enable owners to make appropriate decisions that are complex in relation to timing and quantum of dividends. An example being our decision not to pay a dividend during a period of COVID related uncertainty. This flexibility is welcomed by rating agencies and investors, however, deferring dividends from one year to another does mean that considering a single year dividend decision in isolation can be misleading.

Inflation linked returns are a desirable feature of the energy sector framework and investment proposition. This is particularly important for investors such as pension funds, which have inflation-linked liabilities. It is because of these characteristics that regulated assets attract long-term stable investment capital. Dividends are a fundamental part of the equity case for investment that has driven huge improvement in sector performance and efficiency subsequent to privatisation.

Option 3 – Change to future price control design

Any amendment to the existing cost of debt mechanism must be demonstrably beneficial to consumers and support investor confidence to make long term capital investment. There is a high bar for making a change given the risk of unintended consequences.

As with any price control, we welcome consideration of improvements to existing methodologies. There is limited time between this Call for Input and our sector specific consultation to complete the necessary work to explore the many derivations of options in detail. We welcome Ofgem considering the issue but believe sufficient time should be taken to ensure no unexpected impacts to consumers or investors as a result of any policy change.

Although there is limited detail on the policy options presented, some could be interpreted to be linked to actual company financing decisions. The cost of debt in actual company financial structures will be very different from a notional company, for example, due to timing of refinancing requirements. During RIIO-2, Ofgem acknowledged that our debt book requires exceptional adjustment due to the timing of separation from National Grid and associated refinancing. This item is material and important to keep front of mind when considering policy options. Significant costs were incurred to refinance our debt book in 2017 to the benefit of consumers. This up-front investment from current owners was made possible on the basis of a stable regulatory underpinning. Subsequent to the change of ownership, there has been a rapid increase in investment and improvements in customer performance. Any amendments should not disincentivise future investment of this nature.

Should a change be made for the next price control, there is limited time to respond and adapt risk management strategies within the actual company. As such, we believe the bar is high to consider



making a change for our next price control and significant time should be allowed for any implementation period. Given the modelled quantum of impact is low for those networks participating in the next price control relative to the sector; and importance of ensuring any change is robust, we would welcome a cautious and rigorous approach to impact assessment and timing of implementation.

The Frontier Economics report sets out some considerations over each of the suggested options, but the options cannot be viewed in isolation without also considering interlinked components of the price control that are designed to co-exist with them. The future price controls must operate correctly both as individual policy decisions and as an appropriately calibrated price control package.

We would require further detail to provide informed views on each of the options proposed.

Option 4 – Out or under performance true up

We are strongly opposed to this option based on its harm to consumers and investment in the sector. Frontier Economics sets out in its report commissioned by the ENA the damage that would be caused through this policy option. Particularly in the gas sector where uncertainty over future pathways has reduced the breadth of debt investor appetite to invest long term into the sector. Any perceived benefits from an outperformance true up would be eclipsed by the increased cost of capital, which would be detrimental to our customers in the longer term.

Option 5 – Voluntary submissions by licensees

This is something we already have taken account of in terms of the RIIO-2 business plan and the way we support the communities we serve. We want to be a company that will continue to lead the sector in its performance and strategic thinking. We voluntarily provide over 1% of profits per annum into the Cadent Foundation, equivalent to c. £5m p.a. to deliver on our force for good strategy which is by some way biggest contribution in the sector.

We believe the gas networks can best play its part in the energy transition if there is a whole system-based approach that puts the customer at the heart of the transition over time and that retains optionality as we go forward. Appetite for investment in the gas sector is becoming increasingly costly with a tougher external climate for inbound investors into the UK and gas sector.

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Question 4: Should any other policy options be considered?

We expect that most options will fall into the broad range of policy options commented on above.

We would welcome exploring derivations and the detail of policy options as part of a future price control setting process where appropriate. Regarding policy option 3, narrowing down prospective options over a relatively short time period is critical to enable appropriate due diligence, modelling, assurance and impact assessment to be completed.

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

We welcome discussion on the principles outlined below:

Simplicity in design – the current price control and associated reporting is more complex than at any previous point adding costs to consumers. We have a joint ambition to simplify rather than add complexity.

Appropriate stress testing and impact assessment: Ofgem should permit sufficient time to model, stress test and impact assess any change to ensure that it is demonstrably an improvement under a range of scenarios to the existing mechanism. Implementation should only be carried out once it is clear there will be no unexpected consequences.



The change should be **NPV neutral to networks** under consistent macro-economic assumptions and reduce risk.

Estimates should be **grounded in reliable forecasts with no in-built negative skew via selection bias**. The RII0-2 price control involved reducing most upside incentives to networks. Any assumptions (such as inflation forecasts) used in the implementation need to be balanced avoiding any selection bias.

The **notional company has been the basis for assessing the cost of debt allowance** previously with company's permitted to manage their balance of inflation risk across debt and equity accordingly. Using actual company data will require considerable time to implement and consideration of company specific factors. As Ofgem noted in the RII0-GD2 Sector Specific Methodology Decision (footnote 11 of finance annexe), there are material company specific differences with the timing of refinancing of Cadent debt resulting in over £840m in adjustment to the sector average costs.

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

As noted, we will continue to engage with Ofgem on this matter as part of a future price control. Delivering stable frameworks that support low-cost funding to invest in future network assets is in the interests of both investors and consumers.

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

We have highlighted in our response and associated covering letter where other factors need to be considered.