

SSEN Response to Ofgem's Call for Input:

Impact of high inflation on the network price control operation

26 September 2023



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About SSE Networks

Who We Are

Scottish and Southern Energy Power Distribution Limited is a holding company, trading name Scottish and Southern Electricity Networks (SSEN) which includes Scottish Hydro Electric Transmission plc; Scottish Hydro Electric Power Distribution plc; and Southern Electric Power Distribution plc. They are part of the SSE plc Group, who own 100% of each company, except for SHET plc which, following a minority stake sale in November 2022, is now owned 75% by SSE plc and 25% by Ontario Teachers' Pension Plan Board.

SHET plc, trading name SSEN Transmission, are responsible for the electricity transmission network in the north of Scotland, maintaining and investing in the high voltage 132kV, 220kV, 275kV and 400kV electricity transmission network. More information on this business can be found on our website ssea-transmission.co.uk

SHEPD plc and SSEPD plc trading name SSEN Distribution, are responsible for ensuring a safe and reliable supply of electricity to 3.8 million homes and businesses in communities across central southern England and the north of Scotland. More information on this business can be found on our website ssea.co.uk

Executive Summary

Ofgem announced its Call for Input on the *'Impact of High Inflation on the Network Price Control Operation'* 1 August 2023. This document sets out our response on behalf of SSEN Transmission and SSEN Distribution (collectively referred to as SSEN throughout our response) and is endorsed by the SSE plc Group. This is supplementary to the Energy Networks Association's (ENA's) response which is supported by external analysis from Frontier Economics report *Comment on Ofgem's Call for Input on the Effect of High Inflation*¹,

Inflation is a key cornerstone of regulatory price controls and as such any review of the operation of inflation is complex, requires care, and should be consulted on fully over a period of time. The impact of any changes to the treatment of inflation are of profound importance to the stability and operation of regulatory price controls and we have set out our response as follows:

1. **Inflation indexation of the Regulatory Asset Value (RAV) and use of the real cost of capital is a fundamental component of price controls and has been since privatisation.** It is widely accepted that this structure has allowed regulators to keep the cost of capital lower than would otherwise be the case. Equity investors in networks have long been exposed to differences between inflation assumptions and actual inflation. The treatment of inflation in relation to debt has also been similarly understood to be such that capital markets for long term debt typically raised in energy networks reflect long term inflation. It would therefore be wrong to interpret that investors are experiencing any unexpected short-term benefit when inflation varies from long term averages or forecasts (or Bank of England targets). Moreover, it would be wrong to characterise the recent variations in inflation as being inconsistent with policy intent, which was introduced in the Open Letter as *"to keep real equity returns stable relative to inflation over time"*² and was not observed in Ofgem's documents prior to that.
2. **Inflation is structured throughout the fabric of the price control and care must be taken when analysing inflation or characterising variations in inflation.** It is important that full impact assessments are considered across all elements of a price control and the time periods in which any impact is assessed is carefully selected. It is important to avoid making quick, permanent, and material changes to the operation of a price control based on a perceived issue which is in effect temporary in nature.
3. **No changes should be made to the current or historical price controls.** Any such action would significantly undermine investor confidence in regulatory stability and would not be in the interest of consumers. The UK Regulatory Framework is well respected which has been built up over time where such changes are often considered remote as a result. This concern is particularly pertinent in the context of the elevated investment requirements in the near term to facilitate the government's net zero and energy security targets. This sentiment is clearly shared by debt and equity investors who have expressed similar concerns in relation to the potential retrospective clawback whereby:

'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' **Moody's**³.

Ofgem has previously steered away from making such retrospective changes, ensuring the regulatory framework remains predictable, stable, and attractive to investors. In addition, several regulatory precedents and market reactions observed over time reinforce the potential for the damage retrospective changes to price controls may have on investor confidence and the potential long-term damage to consumers as a result. It is not clear that Ofgem would have been compelled to intervene if the difference had operated in the opposite direction.

¹ Frontier Economics: Comments on Ofgem's Call for Input on the Effect of High Inflation: A report prepared for the Energy Networks Association 25.09.23

² Ofgem, Call for Input - Impact of high inflation on the network price control operation 01.08.2023, page 1.

³ Moody's 'Ofgem outlines possible changes following high inflation' 03.08.2023

4. **Potential changes to future price controls must be carefully considered in detail, and robustly tested in the context of the wider price control package** to ensure that they do not create un-intended consequences that again have adverse effects for consumers; while also reflecting the networks need to secure very significant additional investment to meet the government's net zero and energy security targets. We will continue to engage with Ofgem over the future price control development to ensure any changes are fully considered including but not limited to Ofgem's options for the design of future price controls. Care must be taken to avoid unintended consequences of different options including for financeability, incentives for investment, debt allowances, and the overall basis for setting the cost of capital. There is also the material issue associated with any transition to new arrangements. Ofgem previously set a policy to not interfere in a companies' financing decisions or transfer the risk to consumers for decisions on the capital structure of a company⁴. These are material policy decisions which cannot be made quickly or without adequate analysis and consultation.
5. **Ofgem's current suite of licence obligations and reporting framework around dividends is already comprehensive and have operated successfully for several years.** Ofgem have a range of licence obligations across all energy networks including various restrictions, enhanced reporting obligations, financial resilience obligations, and credit rating requirements. We are willing to work with the wider sector, Ofgem, and stakeholders if there are areas Ofgem determines warrant changes or improvements in the reporting of dividends. We are not however supportive of further obligations and restrictions given what is already in place is substantial and affords Ofgem and consumers sufficient protection on any concerns around dividends.

⁴ This is not to be confused with placing licence obligations on energy networks on financial resilience, credit rating and other requirements to ensure companies manage their financial positions responsibly.

Our Response

Inflation is a key cornerstone of regulatory price controls and as such any review of the operation of inflation is complex, requires care, and should be consulted on fully over a period of time

The impact of any changes to the treatment of inflation are of profound importance to the stability and operation of regulatory price controls and we have set out our response as follows:

1. Inflation indexation of the Regulatory Asset Value (RAV) and use of the real cost of capital is a fundamental component of price controls and has been since privatisation.

It is widely accepted that this structure has allowed regulators to keep the cost of capital lower than would otherwise be the case. Equity investors in networks have long been exposed to differences between inflation assumptions and actual inflation. The treatment of inflation in relation to debt has also been similarly understood to be such that capital markets for long term debt typically raised in energy networks reflect long term inflation. It would therefore be wrong to interpret that investors are experiencing any unexpected short-term benefit when inflation varies from long term averages or forecasts (or Bank of England targets).

It has always been understood that there is likely to be some difference between ex ante assumptions and actual outturn inflation. We note that recent inflation has deviated from the long run assumption that was used to set price controls. However, we are not aware of Ofgem having set out, prior to its Open Letter, any “key policy objective of keeping real equity returns stable relative to inflation over time”.⁵ It is therefore wrong to characterise the recent variations as being inconsistent with policy intent.

Ofgem also consciously decided that differences between allowances for financing costs and actual financing costs would not be shared between customers and investors. This implies that the impact of the difference between inflation assumptions used for the cost of debt allowance and the actual inflation is not expected to be shared between customers and investors. For example, Ofgem stated:

“We have long held the position that network company financing decisions are for network companies and their shareholders and that they then bear the risks of these decisions.”⁶

“We have concerns that implementing debt sharing now risks retrospective capture of decisions or risks taken in previous price controls (when debt sharing was not in place), and that in turn this could call into question regulatory stability.”⁷

There has always been some difference seen between the forward-looking inflation assumptions used to set the price control and actual inflation. Ofgem asserts that: “A similar symmetrical shock below the long run assumption may have compelled Ofgem to intervene”⁸. **It is not clear that Ofgem would have been compelled to intervene if the difference had operated in the opposite direction** because the long period of time over which the difference would affect cash flows would mean that there would be no pressing near-term problem with financial ratios requiring intervention. However, Ofgem are potentially considering intervening notwithstanding the characteristics are relatively similar thereby illustrating it is indeed not being treated as symmetrical by Ofgem. Ofgem’s own modelling of the impact shows that for the majority of RII0-1, networks experienced lower effective returns to equity holders because of lower-than-expected outturn inflation. However, Ofgem did not consider making changes during RII0-1, for RII0-GD2 or for RII0-T2. There is also the fact that the RAV of networks has materially increased over time due to the extensive investment undertaken. This inadvertently skews Ofgem’s analysis of the historical impact of inflation on networks relative to the size of investment, debt books, and overall RAV of energy networks, putting more weight on the years of high inflation due to RAV being higher, compared with the years of low inflation due to RAV being lower.

⁵ Ofgem, Call for Input - Impact of high inflation on the network price control operation, 01.08.2023, page 1

⁶ Ofgem, RII0-2 Strategy Decision – Finance, 24.05.2019, paragraph 2.26

⁷ Ofgem, RII0-2 Strategy Decision - Finance, 24.05.2019, paragraph 2.40

⁸ Ofgem, Call for Input - Impact of high inflation on the network price control operation, 01.08.2023, page 5

2. Inflation is structured throughout the fabric of the price control and care must be taken when analysing inflation or characterising variations in inflation.

It is important that full impact assessments are considered across all elements of a price control and that inconsistencies among them are avoided. The time periods in which any impact is assessed should be carefully selected. It is important to avoid making quick, permanent, and material changes to the operation of a price control based on a perceived issue which is in effect temporary in nature.

3. No changes should be made to the current or historical price controls

Any such action would be contrary to regulatory best practice, would undermine investor confidence in regulatory stability and predictability, and would not be in the interests of consumers. In the near term, networks need to secure very significant additional investment to meet the government's net zero and energy security targets. The consistency and integrity of the regulatory regime helps ensure our sector remains attractive to investment, particularly in the face of increasing international competition. Any retrospective action would unsettle markets to the detriment of consumers.

It is long established standard regulatory practice for changes to the regulatory framework to be well signalled in advance, thoroughly consulted on, and forward-looking. This has been acknowledged by both the investor community and regulators alike, as explained further below.

Investors, analysts, and rating agencies have warned of the risks of Ofgem's retrospective proposals

Investors and rating agencies have commented on the adverse effects that will arise if Ofgem opts to pursue a retroactive course of action proposed in its Call for Input and commentary from analysts provides prima facie evidence that they view any changes as damaging to the extent they do not believe Ofgem would take such drastic steps. Analysts who monitor the impact regulatory changes can have on the financial metrics of traded utilities have published their views - for example:

- *While the direct valuation impact is very limited for both National Grid (1.1% downside to our PT) and SSE (0.9% downside to our PT), as our valuation is underpinned by inflation assumptions similar to Ofgem's low inflation scenario, the bigger impact would come from the loss of investor confidence in the UK regulatory system from any retrospective action. **Bernstein**⁹*
- *Ofgem has made it clear that inflation protection is considered a cornerstone of the price control framework, and that no other inflation mechanisms are in scope. There are a range of policy options put forward, and given the scale of the investment challenge, in our view, it is important that any changes introduced are not retroactive in nature. **Investec**¹⁰*
- *An end of period true-up would be unhelpful for creating the level of certainty that is required for the long-dated investment plans undertaken by the networks and would appear to undermine the regulatory structure within which RIIO was set" **RBC**¹¹*
- *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. **Moody's**¹²*

It is therefore clear that there are material concerns associated with retrospective action for both debt and equity investors. Sectoral regulators and competition authorities have previously highlighted the significant risks associated with taking retrospective action and the potential resulting harm to consumers. We see both the outperformance true-up and solicitation of voluntary contribution by network operators' options

⁹ Bernstein UK Utilities: Our thoughts on Ofgem's Call for Input on Inflation Adjustments on Debt 02.08.2023

¹⁰ Investec Sector Comment: UK Electric Utilities: Ofgem Looking at High Inflation 01.08.23

¹¹ Royal Bank of Canada: Valuation Disconnect in Networks, 23.08.2023

¹² Moody's Sector Comment: Ofgem Outlines Possible Changes following High Inflation, 03.08.2023

being suggested by Ofgem as effectively having the same negative impact on investor confidence i.e. Ofgem's option 4 and 5 respectively.

Ofgem has recognised in the Call for Input that a "true up" mechanism could create significant costs for consumers by undermining the stability and predictability of the regulatory framework.¹³ This recognition also reflects previous statements made by Ofgem in past decisions affirming the reason **not** to reopen current price or past price controls. For example, during RII0-1, Ofgem elected not to re-open the price control during its mid-period review (MPR) noting that:

"Changes to the key financial parameters (e.g., cost of capital) or to clawback outperformance are out of scope and we consider that any such changes could be harmful to consumers' long-term interests."

If we initiate an MPR for RII0-T1 or GD1 and make changes to outputs, we are committed to not making retrospective adjustments, e.g., allowances related to previous years of the price control. We will also not make any changes to the cost of capital or change the totex (total expenditure) sharing factor.

*As stated above, we think such issues are out of scope as they could potentially undermine the regulatory stability associated with an eight-year price control and make companies less likely to commit to long term strategies that benefit consumers. Such changes could also increase the cost of finance from investors as they could perceive this as creating additional regulatory risk. We are therefore conscious of the need to balance the reduction of costs to consumers in the short term with the introduction of regulatory risk and uncertainty, which could ultimately lead to higher costs for consumers. When deciding which, if any, issues to take forward, we will be mindful of the potential risks and downsides of any changes being considered."*¹⁴

Ofgem has previously acknowledged the importance of avoiding retrospective action. For example, one of its "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."*¹⁵

Indeed, these statements from Ofgem are aligned with regulatory precedents from appeals to the competition authorities which confirm the risks associated with retrospective regulation. For example, the outcome of the Competition Commission (CC) appeal by Phoenix Natural Gas Limited (PNGL) quoted Ofwat as saying that 'each company needs to know in advance how the mechanisms will be applied as this will reduce uncertainty in its decision making' and 'wherever possible we should avoid retrospective changes to the agreed mechanisms'¹⁶. In its decision, the CC:

- commented that, in line with normal regulatory practice, its view was that 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*" (para 32); (emphasis added)
- considered that a reduction in the Total Regulatory Value (TRV which is the equivalent of GB energy networks RAV) could have an impact on the perception of regulatory stability and could damage investor confidence in the regulatory framework; and
- stated any impact of this type, which reduces the extent of network expansion, or particularly the development of new supply areas in Northern Ireland, implied a large opportunity cost for future customers who would otherwise benefit from the ability to convert to natural gas.

Another example includes Ofwat's introduction of the GOSM in 2018 in its PR19 consultation; a mechanism for which companies with a gearing above 60% would have to pay back a portion of the perceived benefit from the higher gearing (and notably was subsequently rejected by the CMA for the companies that sought a redetermination of PR19). This change was a significant departure from Ofwat's past policy, which since the privatisation of the sector had have allowed companies to choose freely their capital structure. As a result, Moody's reviewed downward its assessment of stability and predictability as well as its ratio guidance for the UK water sector. Moody's noted that:

¹³ Ofgem, Call For Input - Impact of high inflation on the network price control operation, 01.08.2023, page 9.

¹⁴ Ofgem, Decision on a mid-period review for RII0-T1 and GD1, paras 1.23 – 1.25.

¹⁵ Ofgem, Regulating energy networks for the future: RPI-X@20 Principles, Process and Issues, 27.02.2009, para-2.8

¹⁶ Ofwat 'A further consultation on incentive mechanisms: rewarding future out-performance and handling under-performance of regulatory expectations – a consultation paper', June 2003.

*"In our view these developments evidence a modest deterioration in the stability and predictability of the regulatory regime, in the face of a difficult political environment for the sector. We also see increasing risk of future political interference in the design of the regulatory framework and have changed our assessment of stability and predictability of the UK water regulatory regime under our methodology to Aa from Aaa. To reflect the somewhat increased business risk, given our changed view around the stability and predictability of the regulatory regime and expectation of more volatile cash flow, we have revised our ratio guidance for the sector, such that a UK regulated water company would have to exhibit slightly lower gearing and stronger interest coverage to maintain the same credit quality."*¹⁷

This example demonstrates a direct link between stability and predictability of the regulatory regime and credit ratings. Furthermore, five years later the rating agencies have not reversed this downgrade of their assessment of the water regulatory regime, which demonstrates that a reputation for regulatory stability and predictability can be lost quickly and takes many years to be restored. **Changing the approach to inflation risks inflicting a similar downgrade to the assessment of the energy regulatory regime, with consequent implications for the cost of capital and consumer bills across the sector.**

The inherent risk in making retrospective regulatory decisions is particularly acute given the critical investment needed in the energy industry

It sends a powerful signal to investors that the fabric of the price control is conditional on Ofgem's discretion and may be revisited as and when Ofgem see fit. This hindsight bias will undermine investment, innovation, and improvement in service levels all to the detriment of consumers. Ofgem have previously steered away from retrospective changes on this basis which has ensured the regulatory framework remains stable and attractive to investors.

In accordance with its statutory duties, GEMA is required to have regard to the network operators Financeability Duty. A retrospective change could have a significant negative impact on investor confidence and undermine the perceived stability and predictability of the regulatory framework. As Ofgem themselves recognises in the Inflation Call for Input, this concern is particularly pertinent in the context of the elevated investment requirements in the near term to facilitate the transition to Net Zero.

Damage to investor confidence would therefore undermine the achievement of government priorities such as facilitating the green transition and energy security objectives. To illustrate this point, the National Infrastructure Commission (NIC)¹⁸ published a paper in 2019 which carried out an in-depth study into the UK's major infrastructure needs and made a series of recommendations to the government. The paper focuses on the UK's model of regulation for energy, water, and telecoms with regard to the investment it has generated and proposes recommendations for improvements to the framework. In particular, NIC considers that the regulatory models need to work better for the public, and particularly for consumers, going on to note that *"long-term investors, who bring significant capital and subsequent benefit to the UK market, such as pension funds, value stability and predictability. Investors should receive a fair return on their investments, and be insulated from political cycles by predictable, stable regulation. **To ensure the benefits of predictable regulation, it is important that forward looking regulation should be not changed retrospectively.**"* (emphasis added)

Similarly, a recent 2022 paper published by BEIS on Economic Regulation Policy also highlights that a key element to encouraging investment is *"providing a stable and predictable environment for investors and consumers"*. This paper also references the BIS's Principles of Economic Regulation of 2011 which highlight the need for predictability in economic regulation and specifically note that *"the framework for economic regulation should not **unreasonably unravel past decisions**"*¹⁹.

¹⁷ Moody's (2018), 'Regulator's proposals undermine the stability and predictability of the regime'

¹⁸ National Infrastructure Commission (NIC) – Strategic investment and public confidence, October 2019

¹⁹ Department for Business Innovation and Skills, Principles for Economic Regulation, April 2011, page 5

4. Potential changes to future price controls must be carefully considered in detail, and robustly tested in the context of the wider price control package

The current, complex price control mechanisms were developed following extensive consideration of both the individual mechanisms and the wider price control framework. Considerable work is required to establish whether any changes could be made for future price control mechanisms that would improve on the current arrangements.

Any changes to future price control framework must be robustly tested to ensure that they do not create un-intended consequences that have adverse effects for customers. This must consider how any consequential changes to other aspects of the price control framework would be managed. For example, several of the proposed options would seem to have significant implications for other hugely important aspects of the framework. Ofgem should consider the impact on inflation of the RAV, cost of debt allowances and broader cost of capital allowances, the overall risk of the regulatory framework, and importantly financeability over the long term. The profile of customer bills will also be an important factor to consider while also ensuring investment is retained and enhanced in the sector to deliver NetZero targets.

We note that the suggested mechanisms require more detailed development and assessment so that their impact and appropriateness for a future price control is truly understood. We also would encourage Ofgem to consider retaining the status quo as well as considering other options not suggested to ensure its analysis is comprehensive and is in line with the wider price control design. The various options will therefore have to be extensively considered over the long term i.e., more than one price control, and various elements will have to be considered including but not limited to those outlined in the ENA response. We will continue to work with Ofgem to support this work as part of the process to establish the framework for the next network price controls.

5. Ofgem's current suite of licence obligations and reporting framework around dividends is already comprehensive and have operated successfully for several years

SSEN take its regulatory and fiduciary duties very seriously, including dividend decisions. While customers, stakeholders and investors must be confident that distributions to shareholders are appropriate, the distribution of dividends to shareholders is a fundamental component of investor expectations. 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. Dividend decision-making processes are therefore considered carefully while considering the regulatory and statutory obligations of the company.

Ofgem's dividend policy relies on the nominal cost of capital being achieved by the combination of a real weighted average cost of capital (WACC) and inflated RAV. Any suggestion that this core tenet of the price control could be changed must be treated very cautiously as it goes to the heart of investors' legitimate expectations when they invest in networks and comes at a time when networks are expected to raise new capital required to support the transition to net zero and energy independence.

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. The ENA response includes an appendix which references the list of licence obligations which we have not repeated here for brevity. We take those obligations very seriously, and Ofgem can investigate and, if appropriate, take action if it believes those obligations are not being met.

Ofgem's requirements for reporting of dividend policy and dividends distributed are extensive. In particular, the Regulatory Financial Performance Reporting requirements were introduced to collect accurate and consistent information from networks to help customers and stakeholders to understand networks' performance on a comparable basis.

Conclusion & Recommendation

We ask Ofgem to note the views above and look forward to continuing to work with them to assess the appropriateness of any possible changes to the regulatory price control framework for future price control periods.

Appendix: Our Response to Ofgem's Specific Questions in the Call for Input

1. Have we characterised the issue accurately?

While we agree that inflation is materially higher over the short term, we do not believe it is correct to seek to restate policy intents or indeed propose new regulatory policies as a result. It has long been set in the regulatory framework including in RIIO-1 and 2, that inflation risk on the cost of borrowing resides with network companies. It would be therefore wrong to characterise the issue Ofgem perceives as not intended with regards that inflation varies year-on-year compared to the Bank of England target. The long-term assumption that Ofgem has used aligns with the Bank of England target and therefore year-on-year volatility risks reside with the energy networks. As we have set out in our main response, we do not see it as the case Ofgem would intervene should the opposite be true i.e. inflation was below the Bank of England target. This was the case in RIIO-1 and Ofgem did not intervene at any point during that price control. We also note in our main response that the change in real RAV's over time due to the scale of capital investment skews the analysis and caution should be used when drawing overly simple conclusions.

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.

We have no material concerns with Ofgem's quantitative assessment based on the methodology it has set out. We do believe the bill impact on consumers is larger than would otherwise be the case, and that since inflation is not the only part of a price control it is incorrect to isolate a small element of where inflation interacts in the price control. A more rounded analysis would illustrate further inflationary pressures that remain unfunded. We recommend caution when interpreting such analysis to make changes in established Ofgem policy. This is particularly relevant for future price controls as much as it is for considering reopening past price control decisions. Both of which carry a high bar in relation to implementing changes in regulatory policy including extensive consultation and analysis. As we set out in our main response, we will engage with Ofgem as part of the forthcoming price control alongside all other elements typically included within such a price control. It is important these elements are considered in the round.

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.

As outlined in our response, we support Option 1: **No policy action should be taken to this issue.** Inflation is a key cornerstone of regulatory price controls and as such any review of the operation of inflation is complex, requires care, and should be consulted on fully over a period of time. See Our Response Points 1 and 2.

Option 2 (distribution policy reporting and transparency): Ofgem's requirements for reporting of dividend policy and dividends distributed are already extensive. See Our Response Point 5.

Option 3 (changes to future price controls): Potential changes to future price controls must be carefully considered in detail, and robustly tested in the context of the wider price control package. See Our Response Point 4.

We believe Options 4 (outperformance true-up) and Option 5 (voluntary contribution) are both effectively retroactive adjustments which would significantly damage investor confidence and the future attractiveness of the UK to invest in; undermine regulatory credibility and negatively impact UK energy infrastructure build out, net zero targets and ultimately consumers in the long run.

4. Should any other policy options be considered?

Inflation is a key cornerstone of regulatory price controls and as such any review of the operation of inflation is complex, requires care, and should be consulted on fully over a period of time. See Our Response Points 1, 2 and 4.

In terms of future price controls, we do not believe Ofgem has developed its analysis or range of options fully, including defining what is intended by long term inflation assumptions. This should be done fully as part of the next price control process and no decisions on changes to the precise treatment of inflation in the cost of debt mechanism should be made at this premature stage.

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

While we broadly support the proposed principles for policy design and implementation, these must be considered in detail and robustly tested in the context of the wider price control package. While we agree and support policy symmetry and managing the pace of implementation; a key point to network operators in the forthcoming price controls is financial resilience given the unprecedented level of investment required to upgrade the network to help deliver net zero; along with attracting investors who will help finance this.

We have set out in our main response that Ofgem had a clear stated policy intent regarding year-on-year inflation volatility compared to the long-term inflation assumption used. We have also set out our concerns around changing a policy decision after the fact as well as the asymmetrical nature of any changes. See Our Response Points 1,2 3,4 and 5.

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?

Operating in the best interest of consumers is fundamental to the legitimacy of regulated networks companies and a wide range of considerations are outlined in the proposed evaluation criteria, including protecting consumer interests, ensuring prices are fair for the consumer are efficient; and that there is an optimal allocation of risk between consumers and licensees.

Regulatory stability and predictability are crucial to network operators, it allows them to manage their businesses for the long term in the best interest of consumers, while adapting to near term challenges including geopolitical and market impacts. Securing both adequate private investment and the necessary supply chain are imperative to delivering UK net zero commitments and we encourage Ofgem to maintain this regulatory certainty in order to preserve the UKs well regarded worldwide reputation for its stable regulatory regime. In a recent analyst note, "UK Preferred Regulated Exposure in EU/UK Duel" Morgan Stanley state:

The UK's 'up to' 50GW offshore wind ambition by 2030 has catalysed a trickle down of supportive policy and constructive regulation that adds credibility to the crystallisation of this growth outlook. We expect continued supportive policy and regulation to act as positive catalysts over the short term. Inflation indexation of UK asset bases furthers the appeal²⁰.

We believe that protecting the regulatory stability and predictability as the primary criterion for evaluation particularly given the damage any retrospective or prospective changes would mean for consumers. As we have set out in our main response, there is a comprehensive evidence base alongside a long running policy position across government and regulatory bodies that causing regulatory instability and

²⁰ Morgan Stanley Core View: CIO Brief: UK Preferred Regulated Exposure in EU/UK Duel 25.09.2023

uncertainty would increase costs to consumers. We have also set out that we are not in favour of voluntary plans or indeed believe that the legitimacy of the price control is of concern. See Our Response Points 3, 4 and 5.

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

Potential changes to future price controls must be carefully considered in detail, and robustly tested in the context of the wider price control package. Future price control packages will need to consider the significant increase in investment and the challenges of moving to a cleaner, secure, and affordable energy system, and how this will ultimately be funded by the GB public including:

- Community Benefit for those hosting new transmission infrastructure as outlined in the Winsor Report and already being consulted on by SSEN Transmission
- Securing adequate supply chain in global markets during extraordinary worldwide demand for low carbon infrastructure; and
- The overall financeability of network operators in the next decade and beyond given the sheer unprecedented level of investment they will be required to fund in advance and the impact this will have on financial metrics including cashflows, gearing and cost of capital.

Ofgem should seek to retain its reputation and respected position as an economic regulator at a time when investment in energy networks has never been more crucial to achieve government targets and benefit society as a whole. See Our Response Points 3, 4 and 5.

