Cadent
Your Gas Network

RIIO-3 Sector Specific Methodology Consultation

Cadent Response Executive Summary

March 2024

Executive Summary

Introduction

At Cadent, we are committed to delivering for our customers and facilitating the transition to net zero. We are proud of the progress we have made in transforming our performance (which is now consistently delivering upper quartile outcomes) and to have a clear industry leadership role in key areas such as supporting customers in vulnerable situations. We provide an essential service that keeps people warm and provides energy to over eleven million homes, offices, and businesses across the UK. We will strive to consolidate and continue our progress over the rest of the RIIO-2 period and into RIIO-3.

This summary provides some overarching context and key points from our detailed responses to the Overview, Gas Distribution Sector and Finance Annex documents in the Sector Specific Methodology consultation.

We support the outcome areas for the Gas Distribution sector framework to underpin the critical services we will continue to provide for customers for decades to come

We support the proposed four customer outcomes[1] set out in the Sector Specific Methodology Consultation (SSMC) frameworks and the majority of the proposals. We make some specific suggestions to add detail and help better achieve those outcomes. There are also a small number of areas where we suggest more substantive changes for the Sector Specific Methodology Decision (SSMD) based on our customer and stakeholder insights, practical evidence from our financing activities and the support and challenge of our independent Customer Challenge Group. We trust that proper regard will be given to these proposals.

We are very mindful that our customers are facing a cost-of-living crisis. They are dependent on our networks providing affordable, safe and reliable services to heat their homes and businesses. These customers also face very real impacts and future choices from the transition to net zero. We know our plans will drive a relatively small but important part of the overall energy bill that needs to be managed carefully. The prime focus should be on the determining and delivering value to current and future customers and maintaining investor confidence in the short and long term.

The scale of the transition of heat and industrial energy demand is vast, and more complex than the transition of the power sector given it involves consumers and a much larger scale of energy. The gas networks' role in supporting industrial and power decarbonisation is already progressing with work such as our HyNet hydrogen industrial cluster project. The Heat Energy Policy decision is yet to be made and the role of hydrogen and existing natural gas networks for domestic consumers within it still to be determined. Notwithstanding the different potential outcomes, we anticipate parts of the existing network may need to be repurposed or decommissioned in the future. Our view, however, is that this is likely to be undertaken over decades and we concur with Ofgem's view in the SSMC that nothing material in this regard will be required in the RIIO-3 timescales.

[1] Infrastructure fit for a low-cost transition to Net Zero, Secure and resilient supplies (we suggest adding safe explicitly to this outcome for Gas networks), High quality of service, System efficiency and long-term value for money.

Hence, it is critical that we do not make decisions in the RIIO-3 framework that might inadvertently hasten the decline of the gas network prior to the pathways being determined; that could increase the risk of failing to attract the necessary future investment; or could prematurely increase costs to consumers. We also believe it is important to ensure that any regulatory decisions do not remove potential decarbonisation options for future consumers as well as pre-emptively destroy the value that customers might secure from their historical investment in gas assets. To do so would not be in the interests of existing and future customers. For example, it is therefore critical that we determine the work required to meet the needs of consumers first, before considering how we profile recovering those costs from current and future customers. This will ensure we do not inadvertently undermine the safe and resilient service that customers expect and need by constraining the efficient work needed to deliver it to mitigate a bill increase that might be caused through balancing intergenerational charging considerations through accelerated depreciation.

There is a need to consider RIIO in the round and the positive role of Incentives and returns

It is important to look at the overall stance of Ofgem's proposals in the SSMC. While we agree with much of its approach, we are concerned that it might limit the scope for a well-performing company to earn returns above the cost of capital. We accept Ofgem's view that this gas price control is unlikely to see new investment on the scale of the electricity controls, but we still strongly believe in the model of incentive-based regulation and that companies that deliver for consumers should be permitted to benefit from that delivery. We believe that Ofgem's current formulation does not fully allow for this. When assessing the individual areas of output incentivisation presented in the RIIO-GD3 SSMC, our high case assessment appears to be broadly in line with RIIO-GD2, however the low case would see the removal of a number of positive incentives and further skews the range to the downside (ranging from around -1.0% RoRE to <+0.1% RoRE at a Cadent company level).

We accept that GDNs earned relatively high returns on regulatory equity (RORE) in RIIO-1 (although this was far less so for Cadent), though we also note that the incentives delivered well for consumers through better outputs. Ofgem reacted to this by lowering the cost of capital in RIIO-2, stretching the cost-efficiency benchmarking and heavily constraining output incentives as well as introducing the Return Adjustment Mechanism (RAM) to ensure that any major deviations from expected returns were limited in extent. That allowed both companies and consumers protection from a significant mis-calibration of the price control and we understand why this approach was followed.

So far, the average RORE for GDNs over RIIO-2 appears to be around 5%, or close to the cost of equity. We note that when the RIIO process was first developed by Ofgem it was clearly stated that median performing companies would have a chance to earn double digit real returns[2]. We would not advocate the need to earn that level of returns under the proposed framework and the current macro-economic environment and we accept that all companies are not entitled to high returns. Nevertheless, given the need to transform the entire energy system, creating incentives for gas network firms that align with net zero seems the best way to achieve the goal.

To this end, we suggest that Ofgem consider changes to the financial ODIs that would reward firms for delivering on positive outcomes. ODIs that enable net zero goals, incentivise all GDNs to improve streetworks, and encourage more efficiency in shrinkage issues whilst continuing to drive great customer satisfaction, would provide a better and measured set of incentives and allow firms to focus on delivering for consumers. Ofgem would still have the RAMs mechanism – which we support and consider should potentially be strengthened further – to provide a symmetric protection against either

[2] RIIO-GD1 Final Proposals Overview P38, para 6.22-6.23

too high or too low industry returns within a tighter banding than applied previously. Just as RIIO-1 may have set average returns too high, setting returns too low can impede investment in the sector to the detriment of customers as currently seen in the water sector[3].

We believe there are five important issues for the framework to deliver on for consumers

We have highlighted five areas which we think are critical to delivering value to current and future gas consumers, and where we would urge Ofgem to fully consider and give proper weight to the evidence we have provided when it makes its methodology decision and the subsequent Determinations on business plans. We have ordered these starting with the outputs customers need followed by establishing the workload and costs to deliver them and then ensuring the activities can be efficiently financed:

1. targeting companies to focus on things that matter most to customers and stakeholders as evidenced through robust stakeholder engagement.

2. enabling network companies to continue to prioritise the work of protecting customers in vulnerable circumstances.

3. using realistic and reasonable planning assumptions and providing gas distribution businesses with sufficient funding to maintain and improve the safety and resilience of the networks.

4. ensuring a fair assessment of efficient costs.

5. maintaining the investability of the gas sector.

1. Targeting companies to focus on things that matter most to customers and stakeholders

We support Ofgem's intent to build on the RIIO-2 output and incentives framework. Based on stakeholder engagement, we consider the focus areas for RIIO-3 should be:

- Changing the approach to leakage incentives supporting and encouraging pace to move to observed leakage data, which will enable more targeted intervention and deliver greater benefits to consumers.

- Reviewing the weighting of the customer satisfaction incentives across the existing products and considering whether reinstatement, a disconnection service, and industrial and commercial services could be incorporated.

- Rolling out the collaborative streetworks incentive to all networks. We see this as a great example of the merits of positive incentivisation.

- Net zero transition coordination. As discussed above, we would urge Ofgem to look for further opportunities for positive incentivisation in the framework. We have proposed a new net zero transition coordination incentive which we are developing with our Independent Customer Challenge Group. This idea builds on Ofgem's proposal to encourage greater coordination of activities on net zero within and across sectors, to ensure customers are supported through the net zero transition. At a time when nearly all stakeholders agree that the UK should focus on a whole-system approach to net zero, we believe this would help facilitate cooperation across and beyond the sector.

[3] Ofwat CEO stated (in his oral evidence to the EFRA Select Committee, December 2023) that average equity returns resulting from PR19 are currently at 3% driven through very penal ODI incentives.

- Rewards for new ideas. We support the intention to create rewards for companies that are bringing forward new ideas, and outputs and incentives that customers and investors would value. We will continue to bring forward ideas as we have to date through Ofgem's SSMC working groups.

- More agile application of uncertainty mechanisms and a reduction in the resource intensive nature of re-openers, which has been a feature of RIIO-2.

- Maintaining an annual target for the Emergency Standards of Service. This standard is proportionate and has worked effectively for customers for many years, alongside our statutory duty to attend escapes of gas as soon as reasonably practicable. Targeted and urgent work is required by Ofgem to help remedy the causes of the unforecastable difficulties in meeting this standard during 2022/23, namely the inability of customers to contact suppliers and gas safe registered engineers when they had difficulties with their appliances and meters that were not related to the National Gas Emergency Service.

- Widening the scope of the Network Innovation Allowance and improving the governance mechanisms of the Strategic Innovation fund to encourage and enable wider participation.

2. Enabling work to protect customers in vulnerable circumstances

We remain focussed on the support we provide to our most vulnerable customers. Energy prices are now at significantly higher levels than when the RIIO-GD2 decision was taken, and vulnerable customers will continue to need support. We welcome the proposal to continue support for services that have been enabled by Ofgem's Vulnerability and Carbon Monoxide Awareness (VCMA) use-it-or-lose-it fund. During RIIO-2, this has enabled Cadent to provide vital and life-changing services for those that most need it, including two hundred Centres for Warmth, innovative services beyond the meter and our energy ecosystems collaboration project, which brings together funding from multiple sectors to provide a holistic approach to supporting customers in fuel poverty.

Given the momentum this has driven and the real impacts this is having on customers in need, it is essential to continue and enhance these funds to build on the legacy established through customer services created in RIIO-2. We propose that the VCMA Fund should be set at £62m for Cadent[4]. We also set out our thoughts on what the scope of the VCMA Fund could cover, guided by expert stakeholder input and our experiences from RIIO-2. We will continue to supplement this funding through the Cadent Foundation which is funded directly from our shareholders (at a scale unmatched in the sector).

3. Using realistic and reasonable planning assumptions and maintaining and improving the safety and the resilience of the networks

The RIIO-3 period will be a critical time for consumers as we ramp up the transition to net zero against a backdrop of a cost-of-living crisis and substantial infrastructure challenges in other sectors, such as water and transport. As a result of the uncertainty for gas distribution, we propose using reasonable and realistic modelled assumptions to plan investment for RIIO-3 and avoids the need to heavily rely on specific FES scenarios which are subject to considerable uncertainty and which we have been informed by the National Energy System Operator are likely to change substantially in 2024.

Natural gas usage will inevitably decline over time. While the number of gas connections is likely to reduce over the coming years, this will not result in a correspondingly linear decline in the need for a

[4] This is a level (in 2018/19 prices) between the initial RIIO-2 funding level but below the adjusted RIIO-2 funding level that resulted from repurposing the fuel poor networks extension allowances.

gas distribution network or the need to invest in the gas network to ensure that it is safe and resilient. Most of the investment needed in the gas distribution network is driven by the key objectives of keeping it safe and resilient and are not load driven. The gas distribution network is likely to be needed for many decades to come to ensure all customers, regardless of their living arrangements, have access to heating and cooking. Gas will continue to be essential to support public services and industry, regardless of the speed of change in domestic use, which remains uncertain. We suggest using a payback period assumption of 25 years (aligning this to the net zero statutory date) for non-mandatory and safety/resilience risk spend. For investment planning purposes, we can also use sensible baseline assumptions on disconnections, which are aligned to Government targets on heat pumps. Taken together, this will be sufficient to develop consistent and measured investment plans for RIIO-3.

The price control framework must also enable and give proper weight to the need to deliver a safe and resilient service to our customers, whilst also doing everything we can to reduce our immediate impact on the environment through reducing leakage of methane and enabling options for future customers to make the right choices for them on the transition. With this crucial ongoing role in mind, it is vital the framework supports the ongoing delivery of critical interventions to maintain public safety such as the iron mains replacement programme. We support the initial conclusions of the HSE, DESNZ and Ofgem review which determined that the Tier 1 iron mains programme should continue in its current form, and that further work should be done to assess how work should be prioritised on Tier 2 and 3 iron mains and steel assets which have been the subject of recent incidents highlighting the risks presented by these pipes in the absence of appropriate intervention.

In addition to the safety benefits, the HSE, DESNZ and Ofgem review highlighted that the iron mains replacement programme has a significant impact in reducing methane leakage. As mentioned above, we believe there is a strong case to enhance the incentives and framework around leakage from RIIO-2. This is a great opportunity to build on work Cadent is leading through the Digital Platform for Leakage Analytics (DPLA) innovation programme that will enable a move to observed rather than modelled leakage. This will enable more efficient and targeted asset specific interventions and a proactive rather than reactive approach to managing gas escapes. We are keen to work with Ofgem on developing this framework further as set out in point one.

In addition, we welcome the proposed framework's focus on resilience. We have seen increasing pressure from climate change and its impact on flooding and ground movement which is directly impacting the risks on our underground assets (such as the preponderance of water pipe bursts which are creating water ingress issues on the gas networks). In addition, we support the focus on cyber security against the constantly changing threat landscape. This highlights the need to continue to attract investment into the gas network which we expand on in our point five below.

4. Ensuring a fair assessment of efficient costs

With affordability a key consideration, we welcome the principles underpinning Ofgem's approach to undertake a robust cost assessment process and support building on the learnings from RIIO-2 and the conclusions reached by the Competition and Markets Authority (CMA). We have undertaken a substantial amount of work on cost assessment methodologies to help inform the SSMD and will continue sharing this to support Ofgem in developing the RIIO-3 approach through the Cost Assessment Working Group. Specifically in this response:

- We have set out our views on the criteria for how to determine what assessment approach to use for particular cost types (i.e., what is and what is not comparatively assessed via regression), building on RIIO-GD2 and, where possible, identifying proposed approaches for specific categories of expenditure. Regardless of the criteria set to determine how costs are assessed, however, what is most important is that the criteria are applied consistently across GDNs to avoid any potential biases from removing costs from those to be regressed for some when they are legitimately still included for others.

- We have identified several improvements that are important for Ofgem to consider in its framework for adjusting costs to be assessed via regression analysis for regional and company-specific factors. We have also provided a roadmap for how Ofgem can approach these factors in a different, and complementary way, to its pre modelling adjustments. Specifically, we believe a totex model using so-called ‘density’ variables could helpfully provide an alternative view of regional and company-specific cost impacts that the current framework does not sufficiently capture on its own. This together with fuller recognition of required pre-modelling adjustments could ensure more robust controlling of exogenous cost drivers in the resulting regression assessment.

- We also support proposals to consider the use of more than one totex regression model for setting allowances and have identified a number of areas of weakness in the current set of cost drivers where potential improvement could be made. We believe that it is essential Ofgem establish a clear principles-based framework early for how it would combine models, should it ultimately use several to set allowances.

Despite our networks setting the efficiency benchmark with our RIIO-2 plan, continued cost pressures in the supply market and inflationary pressures are making the assumed 1% ongoing efficiency target unachievable. It is critical, therefore, that Ofgem attach sufficient weight to the available evidence to set a realistic target on efficiency for RIIO-3. The target must reflect realistic trends in UK productivity and ensure real price effects are matched to sector spend profiles.

To ensure a robust cost assessment at RIIO-GD3, ultimately, the testing, iteration and assessment of approaches must be undertaken collaboratively with GDNs throughout the setting of the control. We support the transparent approach taken by Ofgem thus far, through the Cost Assessment Working Group by sharing models and assumptions with GDNs to ensure robustness. We would encourage Ofgem to consult with GDNs post business plan submissions on more detailed and specific cost assessment topics (including consultation on potential models) before Draft Determinations. This would then allow further time for model assurance and refinement before Draft Determinations and a more detailed consideration of issues than is feasible via the SSMC.

5. Maintaining the investability of the gas sector

Investability in gas is at a critical juncture with both debt and equity investors seeing plentiful alternative routes for investing their capital. This includes the large growth signalled in UK water and electricity investment, but also the set of global opportunities in infrastructure and decarbonising, particularly in the USA under the terms of the Inflation Reduction Act.

As we move towards Net Zero, uncertainty over the future role of the natural gas networks has the potential to undermine the investability of the gas sector, increasing financing costs to the disadvantage of gas customers. We consider Ofgem could play a key role in preventing this. Accordingly, whilst we welcome the SMCC’s consideration of these risks, including how to mitigate stranded assets, we would encourage Ofgem to avoid taking decisions that unnecessarily undermine investor confidence or reduce incentives to invest. For this reason, Ofgem is right to consider evidence of the risks and costs of investability in the gas sector during the RIIO-3 process. Based on the evidence and input from investors, rating agencies and our experience of financing in RIIO-2 to date, we highlight four key points that Ofgem must consider in its analysis:

- First, the macro-economic environment has shifted since the start of RIIO-2 to a higher-for-longer interest rate environment. These market realities need to be reflected in the allowed return on capital and we are providing evidence for this based on the latest market data. We accept that the approach Ofgem has taken over RIIO on debt costs has worked well but would ask it to ensure that whatever values its approach comes out with do reflect the increases in debt costs over recent years. We are concerned about Ofgem's proposals for the cost of equity and would suggest that the cost of equity set in RIIO-2 is not sufficient for the level of risk faced by networks in RIIO-3, or reflective of the macro-economic changes.

- Second, for cost of debt allowances, any potential changes in response to the "inflation leverage effect" must be considered and tested very carefully and in a manner that continues to recognise the value and need for regulatory stability and predictability. It has not been shown that the proposed amendments are beneficial to customers over the longer term, and the bar is high to make changes given their importance. We believe investor confidence will be best achieved by retaining the status quo position on the treatment of RAV indexation that has been consistently successful in attracting significant quantities of capital into the sector at low costs to consumers. In any case, significantly more work is needed to develop the detail on all options to address the "inflation leverage effect", including whether they deliver on financeability and investability objectives or require consequential changes to other aspects of the price control package. Ofgem should also avoid the complexity of transitioning to a lower percentage of index linked debt as this will create risks to networks and, ultimately, costs to consumers. The proposed change to weight the debt indexation mechanism to reflect refinancing and new investment requirements needs careful implementation to ensure it is fair and reasonable and reflects the changing dynamic where accessing longer tenor debt is increasingly expensive in the gas sector.

- Third, we do not believe action needs to be taken now to further accelerate depreciation of assets, particularly given the uncertain extent of repurposing and the timescales around this. Any accelerated depreciation should be proportionate and targeted and undertaken incrementally, for example, by starting to consider the position on new investment depreciation profiles. It should not be aligned to inherently uncertain and illustrative Future Energy Scenarios, which may unnecessarily send potentially inaccurate messages to the market, which would not be in the best interests of current and future customers. Without a clear and unambiguous commitment from Ofgem and the Government on RAV recovery, there will be an investor perception that the allowed revenues that we are entitled to recover may be at risk; and this needs to be compensated for.

- Fourth, we agree it is important for the RIIO-3 framework to ensure clarity of the position on the recovery of the current RAV and how repurposing rules and additional decommissioning costs should be handled. These issues are complex and sufficient time is required to fully explore and develop reasonable propositions against a range of potential cases of consumer led or strategically planned energy transitions. We do not believe this can be done properly, taking into account all of the relevant factors, in time for the SSMD.

In conclusion

Our response is aimed at helping Ofgem create a RIIO-3 framework which will enable us to deliver a business plan and attract investment that will continue to deliver safe, secure, and resilient supplies to the customers that need them, whilst carefully managing and planning for the Net Zero over the longer term.

As an industry, it is crucial that we determine the right plans needed to deliver the services our customers demand before we consider other elements of the regulatory and financial framework that will oversee these. That is, we determine the work required to meet the needs of consumers first, before considering how we profile recovering those costs from current and future customers. This will ensure we do not inadvertently undermine the safe and resilient service that customers expect and need by constraining the efficient work needed to deliver it to mitigate a bill increase that might be caused through balancing intergenerational charging considerations through accelerated depreciation. We believe the system of incentive regulation works and that further ODI incentives will deliver better outcomes for consumers while the RAMs mechanism ensures that overall returns will be neither too high nor too low.

Our detailed answers to each of the consultation questions are attached. We have provided these in four separate documents alongside this Executive Summary.

- Overview Document Questions
- Gas Distribution Annex Questions
- Gas Transmission Annex Questions
- Finance Annex Questions

We look forward to working with Ofgem to develop the framework further and would be happy to discuss any aspect of our response.

Yours sincerely

Steve Fraser

Chief Executive