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Dear

*Steve*

**Northern Gas Networks' response to Ofgem's Sector Specific Methodology Consultation for RIIO-3**

Thank you for the opportunity to respond to the Sector Specific Methodology Consultation (SSMC) for RIIO-3. Given the challenges faced by the energy networks in the next few years, it is of key importance that regulatory frameworks remain fit for purpose and are implemented in the best interests of current and future consumers. As outlined in the Future System Network Regulation (FSNR) decision document, we agree that the RIIO Framework remains broadly fit for purpose, however, there are certain aspects that we consider need clear focus and must be addressed through the SSMC decision, namely:

1. Ofgem must implement an appropriately balanced incentive framework that truly rewards frontier performance whilst holding underperforming companies to account.
2. Ofgem must take full account of the macroeconomic risks faced by the Gas sector and define and support a specific view of the future against which it regulates.
3. Ofgem must appropriately calibrate the allowed Cost of Capital for GDNs to ensure that the gas sector is both financeable and investable.

I address each of these in turn below and more complete responses to each question that you have raised in your consultation are provided in Appendix 1 and Appendix 2 with supporting expert reports.

***Balanced Incentive Framework***

Since 2011, NGN have relentlessly embedded a change agenda to transform our business into an agile energy company, that is fit for the future and consistently delivers its outputs at an efficient cost, consistent with Ofgem's regulatory framework. To deliver this change, we addressed four key areas:

1. The introduction of modernised terms & conditions that reflected a 365/24/7 customer centric business. NGN now have almost 90% of colleagues on modern T&Cs and the average age of colleagues has reduced from 49yrs to 37yrs. This has seen a significant reduction in our cost base and much improved resource

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utilisation when compared to other network operators. To achieve this also required significant shareholder investment during RIIO-1.

2. A redesign of our supply chain which replaced large Tier 1 contractors with small and agile Tier 2/3 service providers. This not only significantly reduced our Repex delivery costs, but also improved our relationship with our customers as we were much more intimately involved in the site delivery. Our safety performance is industry leading, and our customer satisfaction has remained upper quartile because of this change.
3. To support business and cultural change, we invested over £25m in a new SAP Hana 4 IT platform, replacing previously outsourced IT services, which did not fit with the agile approach to doing business. Instead of attempting to design an IT system to fit around our existing business processes (which is commonplace in many businesses), we reinvented and reimagined our business processes to match the IT system. This has proved to be game changing for NGN, improving data quality, at the same time, allowing timely critical decision making to the benefit of both customers and assets. NGN are not only a gas transporter, but a data centric business that enables improved customer service. NGN are now progressively exploiting opportunities with AI and developing greater skills around predictive analytics.
4. Finally, to achieve all the above, NGN has been on cultural change journey which has been a great success and underpins the progress we have made to maintain the position as a frontier company.

These changes have clearly differentiated our performance and cost profile from other network companies, and it is essential that the regulatory framework rewards and encourages ongoing performance, while holding poorer performers to account. Our analysis, which we reference extensively in our response, and which has been provided to Ofgem in advance of our submission, indicates that the current framework drives perverse incentives and poorer performing companies have been inadvertently rewarded with higher cost allowances and incentives, while the incentive to drive the frontier efficiency benchmark has been diminished.

Our analysis focuses on the size and strength of the truth telling incentive at GD2 and the value and cost of being the frontier company in the sector and utilised RRP data and Ofgem RIIO-GD2 models (appended to this response). It revealed that the size and strength of the truth telling incentive is not commensurate with the value that NGN, as the frontier company in RIIO-2, delivers to customers across GB through a more stringent cost challenge than the other networks.

Our analysis demonstrates that NGN has the highest value to customers using Ofgem's RIIO-GD2 benchmarking models at c. £211m over 2022–26 and that the cost to NGN of operating at the frontier is also material at c. £30m. This is greater than the cost facing any other GDN and the cost to NGN of operating at the frontier is more than three times the c. £8.5m Business Plan Incentive (BPI) stage 4 reward that it received for its efficient benchmark at RIIO-GD2.

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Ofgem must correctly calibrate the size and strength of any truth telling incentive, alongside the wider package of incentives, to ensure that all networks are appropriately incentivised to catch-up to frontier costs and delivery. We would welcome further engagement with Ofgem to discuss our analysis and the proposals for a correctly calibrated incentive framework for RIIIO-3.

### ***Macroeconomic Risk in Gas***

We welcome Ofgem's recognition of the macro risk environment that the gas sector faces. We note that Ofgem's initial position is to primarily focus on flexibility and future re-openers, rather than defining and supporting a specific view of the future against which it regulates. Ofgem must define its view of the future against which it regulates so that GDNs can effectively and efficiently deliver activities in RIIIO-3. Resilience, ensuring an orderly transition and 'investability' are key constructs that should underpin this approach.

As already discussed above there are certain aspects of the current framework which confer perverse incentives for example in relation to the BPI and efficiency. These are stacked against NGN's delivery of outcomes as a frontier company, whose track record on both cost and performance has been further differentiated in GD2. As an overarching theme, the regulatory regime should be designed to reward and incentivise companies to act in the best interests of consumers. As Ofgem's regulatory regime moves more towards re-openers and ex-post funding, companies need to have confidence that the regulatory regime will reward them when they make the right decisions (for example in anticipatory investments), to avoid decisions being delayed while companies seek regulatory certainty ex-ante. NGN would welcome having high-level strategic engagement where these trade-offs can be considered.

To fail to address/redress this imbalance would be to fail to mitigate the risks of a disorderly transition whereby the user base is not served efficiently and reliably up to the last user cohort. This is especially important in the context of Ofgem's current and new duties including to protect the consumer interest, including vulnerable customers, as well as the new Net Zero duties and Growth duties.

### ***Ensuring Networks are Financeable and Investable***

RIIO-3 presents some particularly important challenges. The macroeconomic and financial market environment has changed abruptly since RIIIO-2 was finalised – in response to global shocks, the Bank of England Base Rate has risen dramatically, as has the cost of Government and corporate debt. This alone has clear implications in terms of the financial package calibration in RIIIO-3.

Further, the risks faced by energy networks are growing - the imperative of meeting Net Zero brings huge challenges across all sectors, including gas distribution. Irrespective of the long-term pathway to 2050, gas distribution networks (GDNs) will continue to be essential for warming millions of homes for decades to come. We must be able to invest to deliver the remainder of the legally mandated Repex programme, which is critical on safety grounds. In addition, we must be able to deliver ongoing investment to maintain a resilient, efficient, and customer-focused system. As a sector we face growing cost pressures driven by demand for the materials

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and labour inputs that are needed to deliver these investments; and the growing complexity of legally driven work that must be done.

Meeting these investment challenges requires a price control that is financeable and investable. We, therefore, welcome Ofgem's introduction of the concept of 'investability' in RIIO-3 and we have put forward proposals for how this can be applied in practice. We consider that an imperative to attract and retain finance to be able to deliver critical infrastructure to meet Net Zero is just as important in the gas sector as it is in electricity. Our customers will benefit from a RIIO-3 proposition that properly reflects and compensates for the risks investors face, especially in the context of growing competition for capital.

Of particular note for the gas distribution sector is the growing risk now posed by the widely divergent range of long-term demand scenarios. There are many plausible scenarios in which the gas grid has a long-term future that is critical for UK customers – delivering clean energy where and when it is needed. At the same time, technology is developing rapidly, and Government policy remains highly uncertain – meaning there are some scenarios where gas distribution network utilisation falls dramatically by 2050. We agree that this raises the question of how the investment that has already been made by GDNs (and will continue to be made) should be recovered and Ofgem is right to consider depreciation policies, however, this is only part of the solution. If there is no binding Government commitment to underwriting any residual RAV beyond 2050, our investors will bear the risk that some investment may not be recovered. Debt market evidence demonstrates clearly that gas sector investors are now pricing in a growing risk premium over electricity, which is also reflected when comparing beta estimates across the sectors. It is essential that Ofgem acknowledges this and compensates for this additional risk in its allowed cost of capital. We are also keen to work with Ofgem and the Government to jointly develop and assess the options for mitigating long-term stranding risk in the interests of our customers – particularly vulnerable customers who may otherwise face steep tariff increases in the longer term.

Ofgem has also set out several proposals with the aim of enhancing financial resilience. We consider that the existing arrangements are already strong, comprehensive, and sufficient to ensure the financial resilience of GDNs and thereby sufficiently protect customer interests. There is no evidence that the GD sector is not financially resilient, and therefore no clear rationale to introduce new measures (some of which could, if implemented as proposed in the SSMC, themselves create unnecessary additional costs for customers). NGN has always been a responsible corporate citizen and we will continue to ensure a financially secure and long-term resilient business that can serve our customers' needs. Going forward, our ability to ensure financial resilience will also depend on how Ofgem calibrates the price control and allowed returns.

NGN is an ambitious company, driven by the motivation to improve performance across the industry and a desire to do the right thing for our customers and our region. It is essential that a stable, forward looking Regulatory Framework is implemented in RIIO-3 that provides the opportunity to extend this for the benefit of all stakeholders and we are committed to working with Ofgem and sharing our experience to influence and support the development of the RIIO-3 approach. Please find our responses to the consultation in the appendices to this letter.

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If there are any queries, additional information or clarity required for any of the NGN responses, please contact Greg Dodd, Regulation and Strategic Planning Director, [gdodd@northerngas.co.uk](mailto:gdodd@northerngas.co.uk), who will be able to deal with your query.

Kind regards



Mark Horsley  
Chief Executive Officer  
Northern Gas Networks

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