Cadent
Your Gas Network

RIIO-3 Sector Specific Methodology Consultation

Cadent Response to Ofgem Finance Annex

March 2024

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Note on Supporting External papers & Foreword

Note on Supporting External papers

Set out below are reports that we reference in our response to this Sector Specific Methodology Consultation (“SSMC”). Some of the reports have been commissioned solely by Cadent, some jointly with the other gas distribution networks (“GDNs”) and some through the Energy Networks Association (“ENA”).

Subsequent to the submission of this written consultation response, we welcome continued engagement with Ofgem on these technical reports. We will also be providing further evidence (for example a debt investor survey completed by an independent 3rd party) which, due to limited time scales, it has not been possible to submit in parallel with this response. However, we will provide this document in time to ensure Ofgem can have proper regard to this important evidence.

Ref	Author	Title	Date	Commissioned by	Confidential
FA1	NERA	Additional Cost of Borrowing for the RIIO-3 Price Control	2024	ENA	No
FA2	Oxera	RIIO-3 Cost of Equity	2024	ENA	No
FA3	Frontier Economics	Equity Investability in RIIO-3	2024	ENA	No
FA4	Frontier Economics	The Low Beta Puzzle	2024	ENA	No
FA5	KPMG	Credit Rating Agencies’ perception of Risk for Gas Distribution Networks (GDNs) under RIIO-3 and beyond	2024	GDNs	Yes
FA6	KPMG	Debt Market Analysis: Gas Distribution Networks and UK Regulated comparators	2024	GDNs	Yes
FA7	NERA	Impact of GDNs’ Reduced Debt Tenor on Additional Cost of Borrowing at RIIO-3	2024	GDNs	No
FA8	Oxera	Risks and Investability of the GB Gas Distribution Sector	2024	GDNs	No
FA9	KPMG	The impact of refinancing on cost of debt and implications for reporting	2018	Cadent	Yes
FA10	First Economics	RIIO-2: Prior Year Adjustments	2020	ENA	No
FA11	NatWest Markets	UK Utilities – New Issue Concession Evolution over the last 10 years	2024	Cadent	No
FA12	Frontier Economics	Initial consideration of break-even inflation for price control purposes	2024	ENA	No

Foreword

The ability of networks to meet the challenges of the net zero transition rely on maintaining efficient access to capital markets; to fund the investment in our networks to ensure a resilient supply to our 11 million users. The price of this capital is changing in light of the significant shift in interest rates since the RIIO-2 price control was set.

The ENA has commissioned a number of reports and submitted a response that we support, summarising the key arguments made by our consultants in jointly commissioned work. We do not aim to replicate this analysis here, but welcome further engagement with Ofgem to better understand this evidence prior to concluding on decisions via the Sector Specific Methodology Decisions ("SSMD").

The GDNs have also jointly commissioned work focusing on our changing sectoral risks impacting investability, and our cost of capital. This analysis is important in a changing environment for gas distribution networks, and we ask Ofgem to include this evidence and further engage on this prior to finalising decisions.

Attracting and retaining equity capital

Macro volatility and higher interest rates means rolling forward the RIIO-2 approach does not result in a fair assessment of the cost of equity. Ofgem will need to make adjustments to its RIIO-2 Capital Asset Pricing Model ("CAPM") parameter estimates to reflect latest market conditions and new evidence.

As highlighted in the Frontier Economics[1] report on equity financeability, when setting the Total Market Return (TMR), Ofgem and regulators have used their judgement to reduce it in times of lower rates. The TMR will need to increase relative to RIIO-2 to reflect the current reality.

In the UK, we have also seen National Grid plc take a strategic pivot towards electricity and away from gas networks. As there is currently no UK listed equity with gas transmission or distribution included, it is even harder to be confident that the beta estimate is accurate when using the comparator set included in the SSMC. However, the debt capital markets are used by all market participants and can be used to infer the risk premium being applied. To test whether any point estimate within the range is investable, both Oxera and Frontier Economics independently recommend using tests that consider whether the return on equity is sufficient when calibrated against the cost of debt, and the evident difference in risk between these two classes of investment. There is clear cut evidence that debt investors price gas distribution risks above other utilities, inferring returns need to increase for our sector.

A technical roll forward of the RIIO-2 assessment of CAPM does not derive an appropriate outcome in light of the changing macro and risk environment. To validate this position, we have re-run the cross checks applied by Ofgem for RIIO-2 and they have all increased, significantly, supporting the fact that the cost of equity is moving up.

[1] Supporting Consultancy work - Report reference FA3

Given the importance of the gas sector to the UK's energy resilience we ask Ofgem to consider this evidence and appropriately and reasonably reflect the changing macro and risk environment into the allowed returns and incentives framework. In our response and accompanying advisor reports, we are not replaying evidence that has not been supported through recent regulatory precedent. We are updating evidence since RIIO-2.

Maintaining efficient access to the debt capital markets

Cadent is one of the largest utilities in the UK and attracts debt capital from the international debt capital markets. Having been very active in the different markets over the last 18 months we are well placed to understand the factors impacting investor demand and pricing. Fundamental to and underpinning all investment decisions are the strength and stability of the regulatory framework provided by Ofgem, the underlying credit metrics and longer-term visibility of cashflows.

The investability of the sector is supported by the signals provided by these market participants. It is key to maintain stability; by managing change transparently and with caution to avoid unintended consequences / shocks; and ensure signals provided do not undermine the long-term investment needed to ensure the financial and operational resilience of our networks. It is not in consumer interests to risk the financial and operational resilience of our networks, which will have a key role to play for decades to come.

The past is not a full and accurate assessment of the future risks facing investors in our sector. Investors in gas networks are becoming increasingly risk averse the closer we get to 2050, when government policy targets net zero. With lack of clarity, they in part look to Ofgem to make balanced decisions which recognise the uncertainty and different future options; and not inadvertently create policy. The external environment is changing relatively quickly and concerns over the different pathways to net zero and recovery of past investments is resulting in increased investor sensitivities. We have commenced an investor survey to provide the independent evidence which we strongly believe will support the opinions provided in our response. We welcome Ofgem's engagement on this topic following submission of this SSMC response.

This changing investor landscape is impacting demand, efficient pricing and execution at longer tenors, and refinancing requirements. As we look to the end of RIIO-3, we may be issuing long term debt into a market that is even more uncertain than today depending on the outcome of future government policy decisions and customer behaviour changes. We may see investor concerns increase, pricing rise further and the number of investors able to participate in the gas sector reducing; either to meet ever more stringent ESG criteria; or those seeking, for example, an amortising profile to reduce refinance risks. This market backdrop needs to be factored into the technical elements of the SSMD through calibration that acknowledges and provides for these uncertainties and changing landscape.

Similar to Ofgem and investors, credit rating agencies ("CRAs") are trying to understand the impact on financial and business risks of different scenarios. They also look to Ofgem to provide direction in terms of a reasonable scenario to base their assessments on. We have commissioned KPMG[1] to interview the three main rating agencies about their assessment. Importantly, stability and consistency of regulation along with a view that the RAV is fully recoverable through strong regulatory support underpins this assessment. We welcome Ofgem's commitment to this and agree with Ofgem (as noted in paragraph 8.37 of the RIIO-3 SSMC Finance Annex) that it could undermine regulatory stability and likely not in consumer interests for asset stranding risks to reside with investors. CRAs are expecting an evolution of demand and will revise target metrics based on this change to business risk and changes to the regulatory framework. This transition will need to be included in the financeability assessment.

The SSMC proposals in relation to cost of debt funding included many inter-related factors creating some uncertainty, for example, the notional company approach to managing interest, inflation and refinancing risks; in parallel with potential changes to how the RAV is depreciated. This could lead to unintended consequences so we welcome further engagement with Ofgem as we narrow the options. We would advocate for simplification where possible, managing change transparently and potentially in stages over time (i.e. not through a single reset) - ensuring any transition risks are appropriately managed.

We support the introduction of the concept of investability into the RIIO-3 framework. Without a clear and unambiguous commitment from Ofgem and the Government on RAV and revenue recovery, there will be an investor perception that the allowed revenues that we are entitled to recover may be at risk. This cannot be fully mitigated through revenue acceleration tools. The notion of investability is key to retention of capital and attraction of new debt and equity into our sector.

[1] Supporting Consultancy work - Report reference FA5

Allowed Return on Debt

Allowed Return on Debt

Key message

We continue to support the use of the notional company and that it is appropriate to apply a benchmark to actual company performance. As was the case in RIIO-2, Ofgem should adjust the benchmark upwards to account for Cadent specific refinancing costs that resulted from the separation from National Grid valued at c.£300m for RIIO-3. This benchmark should also adapt to the changing macro and risk environment and include the use of derivatives where they efficiently deliver risk management and where they are included in other parts of the framework.

We continue to support indexing cost of debt and understand that Ofgem is seeking to create a more dynamic mechanism. In the gas sector, it will be important to appropriately adjust for the difference between the embedded debt costs and new issuance costs given the changing market dynamics.

The benchmark of iBoxx utilities 10+ does not reflect a notional GDN issuance both in terms of credit spread and tenor. This needs to be taken into account via an up-lift to the iBoxx for the gas distribution sector. We ask Ofgem to consider the extensive evidence provided by KPMG[1].

The evidence is not clear cut that resolving the "leverage effect" as described within the Autumn 2023 call for input is in consumers interests, particularly within the gas distribution sector. As such we do not believe that any inflation adjustment is appropriate or required. Transitioning to a lower proportion of index linked debt will come with a significant cost to the consumer.

The additional costs of borrowing are increasing relative to RIIO-2. We ask that Ofgem considers sectoral differences in setting additional borrowing costs as refinancing assumptions are integral to the calculation; and new issue concessions are higher and could widen in future in the gas sector. In the report provided by NERA[2], it shows the additional costs of borrowing at 67 bps, 10 bps higher than their estimate for the wider sector as a result of reducing tenor and increasing cost of carry.

FQ1. Do stakeholders consider there to be good reasons to deviate from the overall approach set out under UKRN Recommendation 8?

UKRN Recommendation 8 states that for Cost of debt: Regulators should estimate an allowance for an efficient company under the notional financial structure, with actual debt costs suitably benchmarked against other market evidence.

We continue to agree with this approach and, as set out in our responses below, we support UKRN's Recommendation 8.

[1] Supporting Consultancy work - Report reference FA6

[2] Supporting Consultancy work - Report reference FA7

Calibrating the benchmark: Ofgem appropriately calibrated the sector costs to include Cadent specific financing costs in RIIO-2. This assessment remains valid into RIIO-3

During the RIIO-2 process we provided evidence (through a KPMG[1] report re-submitted with this response) to Ofgem about one-off costs associated with the segmentation of Cadent from National Grid and how they should be included in the sector average to reflect the all-in economic costs of Cadent over time.

The costs related to refinancing and included a part-novation and part-repayment of relatively expensive existing debt as well as raising of new debt at lower rates.

As a result of the refinancing, the gas distribution business now pays significantly lower coupons on its existing debt. If the refinancing had not happened, then the current cost of debt for Cadent would be higher over the medium term. A large part of our current debt portfolio was priced in a single year (FY16/17) due to the segmentation when market rates were low.

The intent of the segmentation was to transfer National Grid's debt across to Cadent. However, due to the complexity and cost of this process, the novation of all debt was not possible. As such, expensive National Grid legacy debt was repaid, and new cheaper debt was issued at the low prevailing market rates. Significant costs were incurred to repay the old legacy debt and secure a much lower ongoing cost of debt effectively accelerating future cash payments. Bondholders and banks were paid the difference between the cost of the old expensive debt and the market rate of new debt as compensation. These one-off costs incurred at various points during the segmentation are recorded in the statutory accounts of various entities and National Grid's Annual Report and Accounts (2016/17, page 77) clearly states that these debt restructuring costs were a result of the segmentation of the Gas Distribution business.

Ofgem cross checked and adjusted the sector average to reflect this. Footnote 11 (pg. 17) of the RIIO-2 SSMD finance annex stated:

"One way to estimate the all-in cost of debt is to base the analysis on the cost of debt observed prior to the refinancing. This is the method Cadent used in submitting an adjusted RFPR (not published but was noted in footnote 4 of Regulatory financial performance annex to RIIO-1 Annual Reports 2018-2018). The absolute value of this adjustment using this method is estimated as £842m. Ofgem has performed a cross check on this estimate, based on public information relating to repurchase prices for NGG and NGET bonds associated with the tender and refinance and market prices calculated based on Bloomberg quoted credit spreads of these bonds on the day prior to the tender announcement. This cross check results in an estimate of £845m."

An analysis of the cost of debt based on the coupon rates now being paid on the new debt post refinancing would omit significant costs directly associated with the refinancing, which enabled it in the first place and, therefore, does not represent the actual all-in economic cost of debt including associated costs incurred upfront as part of the refinancing and separation.

We will resubmit evidence in relation to the impact of the refinancing adjustment for RIIO-3 but sharing the above now for awareness. We estimate that 35% or £295m of the costs relate

[1] Supporting Consultancy work - Report reference FA9

to the RIIO-3 period.

The benchmark should be appropriately calibrated to ensure that the changing risk landscape is factored into the assessment

We highlight below the importance of recognising that we have started to see a change in how investors are assessing the sector risks. The market evidence used to benchmark debt costs should include, as much as possible, this changing risk landscape and suitably reflect the latest evidence, congnisant that during RIIO-3 uncertainty may only increase.

Actual companies use various tools to efficiently access capital markets such as issuing in inflation linked format and accessing international markets to diversify the investor base. They also seek to minimise costs by using derivatives to deliver risk management where more efficient. The notional company should accurately benchmark to actual company's by allowing derivative costs where they can be observed to efficiently deliver risk management and as such in consumers interests.

FQ2. Do stakeholders have evidence in support of or opposition to one or more of the updated indexation or inflation remuneration methodologies under consideration?

Indexation of interest rates: fairly funding the notional company for changing interest rates

Amending the trailing average from a simple average to RAV weighting may resolve some of the dynamic changes in sectors funding needs in the longer term but requires differentiating between embedded debt and future debt

We recognise there may be merit in Ofgem's proposal to introduce a RAV weighting methodology however we believe that this can be introduced most effectively by differentiating between embedded debt and future debt which will be subject to the RAV weighting methodology.

As reflected by the breadth of finance elements that are being consulted on by Ofgem, RIIO-3 is seen as a step change from RIIO-2, with the transition to net zero receiving a much greater focus than previous regulatory periods. We see this as a shift in focus, not just by the regulator but also by investors (further details below). As such, the main reason for requiring a split between embedded and new debt is that the markets in which embedded debt was raised is likely to be materially different to that raised in future regulatory periods. This would support calibration of allowances relating to new debt on a sector specific basis (for example as the cost of debt, tenor of debt or quantum of debt issuance may differ) but would not support calibrating the component relating to the cost of embedded debt on a sector specific basis.

For consistency with RIIO-1 and 2 calibrations of the cost of debt allowances, it will be critical to maintain a cross-sectoral approach to setting allowances for all debt issued prior to RIIO-3 to support provision of a stable and consistent methodology for funding these costs across price controls, in line with the long-term nature of debt issuance by networks.

We acknowledge that splitting debt between embedded and new increases the complexity of the calculations which support the cost of debt allowance however we believe that once implemented, it will provide clarity to the market and avoid requirement for significant adjustments.

We have issued a debt investor survey to understand the drivers of investor assessment of risk and the differential. We will share results shortly after the SSMC response but are confident that they will confirm that the position laid out in this response is consistent with investor views.

The benchmark of iBoxx utilities 10+ does not reflect a notional GDN issuance both in terms of credit spread and tenor

The iBoxx utilities 10+ index includes bonds issued by Cadent and other strong investment grade issuers. We have two fundamental concerns with the index:
(1) the weighted average tenor of the index may be longer than an efficient GDN can be expected to effectively deliver in RIIO-3 and beyond; and
(2) the mix of issuers who make up the index have very different risk profiles with some issuers delivering below the "average" of the index and others above.

The debt market analysis completed by KPMG[1] (report attached) shows that the average tenor of debt issued by GDNs since 2022 is 10 years, below the 14-year trailing average which will be used at the end of RIIO-2. This reduction in average tenor for GDN issuance reflects a change in debt investor appetite for 'gas assets' and is a key differentiator between gas, electricity, and water sectors, all of which feed into the iBoxx index. The conclusion on spreads widening and shorter tenors is consistent with other reports provided from NERA[2], Oxera[3] and through the KPMG[4] research from Credit Rating Agencies ("CRAs") interviews. The KPMG[1] report also highlighted that all three main agencies see uncertainty around the future levels of network utilisation which may pose risks to the credit quality of GDNs, driven by a lack of clarity on heat pump deployment and the degree of gas distribution network re-purposing. Investors place great reliance on the views of CRAs (as well as Ofgem) and the level of uncertainty around the future changes in demand for the gas network is creating cautiousness amongst investors resulting in a shortening of tenors.

This is not to say that tenors above 10 -12 years are not still achievable, however recent discussions with our relationship banks and investors have shown a clear preference for shorter maturities and in particular before government policies on gas boiler phase out (2035). Issuing tenors beyond this are understood to attract higher rates/new issue concessions and have higher execution risks. We believe this is a main driver for the reduction in the average tenor for new GDN issues as highlighted above and see that this needs to be reflected in the assumed tenor achievable for the notional company (i.e. the tenor used in the cost of debt allowance calculation). This is aligned to Ofgem's stated objective within the SSMC to inform the length of the trailing average by using "capital market data and actual issuance trends" rather than placing reliance on the historic calibration exercise.

As well as tenor dynamics, changing investor appetite is also impacting the spreads/margins required by debt investors to reflect the perceived increase in risk between gas and other utilities. This is reflected in the KPMG[1] debt market analysis report which shows a clear divergence over recent years between GDN and electricity network spreads, with GDN debt

[1] Supporting Consultancy work - Report reference FA6
[2] Supporting Consultancy work - Report reference FA7
[3] Supporting Consultancy work - Report reference FA8
[4] Supporting Consultancy work - Report reference FA5

now priced significantly higher than electricity networks. Accordingly, basing the cost of debt allowance on a benchmark which includes non-gas utilities could lead to an average yield which is unachievable for GDNs, with the KPMG[1] analysis showing a premium to the iBoxx average of 14ps for GDN new debt issued since 2022.

Accepting that there are limited alternatives to the iBoxx, we suggest an additional margin is applied /incorporated into the cost of new debt above the iBoxx to reflect the divergence in interest costs for GDNs versus other utilities within the benchmark.

Managing inflation risk: funding the cost of managing inflation exposure

Reducing or eliminating the "leverage effect" as described in the Autumn 2023 call for input will come at a cost to consumers and should be carefully managed

There has been a long-standing approach whereby networks, along with their shareholders, could judge an appropriate level of inflation risk to absorb. Inflation linked debt and derivatives ("ILD") are used to manage this judgement with shareholders accepting the risk to the downside when inflation is low. This was considered a fair approach to risk and reward between networks and customers as inflation could be higher or lower than long-term averages. Long term risk management strategies are currently in place relative to this framework.

This approach has allowed networks to diversify funding sources and attract significant investment into the sector and should not be changed. It also resulted in changes to capital structures and risk management strategies as a consequence of inflation volatility.

We understand that the intention of the options presented is to reduce or eliminate the "leverage effect", as described within the call for input conducted in the Autumn of 2023, however we note that there has not been sufficient evidence that the benefits will outweigh the costs to the gas distribution sector customers.

Option 1, which seeks to match fixed rate debt with a nominal rather than indexed allowance, will result in customer bills being further impacted in the short term which would mean that existing consumers pay a higher charge for deriving materially the same value from their use of the gas network. While Ofgem see that this option as having a neutral cumulative impact over the long run, it will in any case still create higher volatility in charges; and potentially add to the business risks in the long run as the equity buffer from the RAV reduces.

Option 1 also poses a challenge to investability as, by removing the inflation exposure on fixed rate proportion of RAV, it will likely make the sector less attractive given that a proportion of both revenue and RAV would not grow with inflation. This challenge is further heightened by the potential for a transition period which would result in the removal of all ILD, and in turn an assumption that all debt is fixed rate.

Further, networks could be impacted by a mismatch between actual fixed rate debt and the level assumed by Ofgem (as discussed below) and overall, there is no evidence that option 1 is better than the status quo and in customers best interests.

Option 3 appears to be designed to reduce the inflation leverage effect through an upward bias to the inflation forecast. This does not appear to meet the policy ambition of eliminating the "leverage effect" but rather skews the probability of under/over performance to the downside. This would need to be compensated elsewhere to ensure a "fair bet", and avoid financeability risks, eroding any value to customers from the change. Using an inflation forecast such as breakeven is not appropriate. The ENA response and accompanying Frontier Economics[1] report which we support provides details of why the sector does not believe in the use of breakeven inflation as a suitable inflation forecast. Forecasts of long-term inflation should be credible and independent, and it is not clear why an alternative to the long-term OBR forecast currently used at RIIO-2 is required. We would therefore recommend continuing with the current approach of using the long-term OBR forecast, which is well established, simpler to use, and ties in with the Bank of England MPC's remit from the UK Government of managing inflation to 2%. In summary, there is no evidence that option 3 is better than the current method or why an alternative is required.

Option 2 addresses a number of concerns we have with Options 1 and 3 by reducing Ofgem's concern around the "leverage effect" on fixed rate debt while maintaining a proportion of indexation based on outturn inflation, albeit potentially subject to a transition to zero which we do not believe is necessary (as discussed below). This option (without a transition) reduces customers' exposure to volatility in inflation while also limiting the impact on investability. Our main reservation with this option relates to our concern on how transition could be implemented, which also applies to Option 1; and the complexity of calculating the revenue allowance becoming significantly more involved.

Transitioning index linked debt in the notional company from 30% to a lower value will create a mismatch between the inflation exposure of the notional and actual company positions that are long term in nature; adding risk to investors and costs to customers

Under options 1 and 2 in the framework, which aims to remove or reduce the inflation "leverage effect", they would have the effect of inversing the inflation exposure that networks have put in place. By taking a long-term view and assuming a stable regulatory backdrop, Cadent has secured long term financing including long dated RPI debt that matures 2049. This debt will likely grow with inflation (RPI) but the notional company RAV that matches these liabilities may no longer increase with outturn inflation. This creates a risk to Cadent whereby if inflation is above the long run average, we experience the higher costs that are not matched by revenues or RAV growth. i.e. the inflation risk management we currently have in play is inverted directionally. Managing this mismatch (along with RPI / CPIH mismatch) will come at a cost to networks and consumers.

We do not believe that Ofgem should transition the ILD element of the notional company to a lower percentage. Options available will significantly reduce the "leverage effect". The cost to the consumer of reducing to a lower % will be higher than the benefit of the policy ambition of completely eliminating the effect.

To demonstrate how transition will add costs to networks and customers; it may be possible to swap out this risk using financial instruments (i.e. receive inflation, pay fix). Discussions with our banking group have shown a very limited market for this type of trade (with other utilities representing the vast majority of counterparties on the other side of inflation swaps) and it would see networks incur additional costs and lose value from existing trades. Recovering these additional costs, or suitably adjusting the WACC to reflect the change in risk from the extant instruments, due to a change in regulatory approach would present an additional cost to consumers.

[1] Supporting Consultancy work - Report reference FA12

Companies have regard to the notional structure in order to protect exposures under the regulatory framework and any change to the notional structure needs to be carefully considered and be subject to tests which show that any change is an improvement to the existing framework supporting Ofgem's duties in relation to customers and network financeability. If Ofgem do decide to reduce the index linked debt in the notional company via a transition period, it should also consider derivatives, which convert nominal rates to inflation linked exposure, and allow a reasonably long duration to ensure fairness to all licensees, avoiding winners and losers. These derivatives are allowed by rating agencies in their consideration of credit metrics (subject to suitably long tenor) and can be a more efficient method of delivering inflation risk management than primary market issuance in inflation format.

We understand that certain derivatives have previously been excluded in the assessment of sector costs in calibrating the average sector costs. However, it is important to ensure that the notional company assessment of ILD is consistent with how companies have managed their inflation risk, influenced by expectations for stable regulatory treatment of ILD.

Inflation linked debt is important to how the sector delivers strong credit ratings, reduces costs to the consumer; and supports the investability of the sector

ILD is not just a risk management tool for networks to manage their inflation exposure. It is also used to reduce cash interest costs by incurring real, rather than nominal coupon interest costs, improving interest cover metrics, which are used by Moody's in their financeability assessment, but also are entrenched into financial covenants. This enables companies to fund larger capital programmes while maintaining financeability and/or maintain more headroom to adverse market movements. Customers also benefit from a more stable service over the long-term from higher levels of financeability and a lower cost of capital as a result of inflation linked debt.

A reduction of inflation linked debt to 0% would depart from the current established framework and introduce a significant variance to the current level that companies have in their capital structures

Ofgem has a duty to have regard to the Better Regulation Framework (BRF) principles, which state that regulatory activities should be transparent, accountable, proportionate, consistent and targeted.

Under the principle of targeting, regulators should be focused on the problem, and minimise side effects. Addressing the impact of inflation volatility through the proposed approaches by Ofgem, by eliminating or reducing significantly the ILD in the notional capital structure, will have material side effects.

Alternatives may be more effective and cheaper to apply. The Call for Input conclusion and next steps document has not taken forward several approaches to the SSMC and failed to provide clear justification, for example the cap and floor for inflation performance.

As such, in the interests of "fairness" to licensees, and to ensure consistency of regulation and minimise the quantum of change in a brief period of time, we request that Ofgem does not change the level of index linked debt within the notional company. If c.30% of the RAV linked to debt retains the inflation "leverage" effect and evidence from the sector is that debt books are broadly aligned to this level of inflation exposure, then the effect is ultimately removed or reduced to very low levels, with companies likely to align to the level of ILD within the notional company.

FQ3. Do stakeholders have views on the potential approaches to implementation of the proposed methodology changes, including assumptions relating to ILD weights?

As discussed in the response to FQ2.

FQ4. Do stakeholders wish to propose any other alternatives that have not been proposed?

Alternatives have been discussed within the responses to FQ2.

FQ5. Do stakeholders have any additional evidence for us to consider in our review of the additional borrowing allowances or infrequent issuer premium?

Additional borrowing costs have increased and should be reflected in cost of debt allowance.

We refer Ofgem to NERA's[1] report attached that calculates the additional costs of borrowing for the wider sector and their supporting note that focuses on costs for the Gas Distribution sector. The latter points to a range of 67-95 basis point for our sector. The ENA response summarises the position of the sector as a whole.

As set out within the report, a number of inputs to the additional borrowing cost calculation have evolved, reflecting a change in the economic and market environment. Importantly these calculations are based on an assumed tenor, and we need this to reflect the forward-looking assessment of an appropriate tenor in the gas sector. As previously outlined, the tenor of new GDN debt has been reducing and is now 10 years, so rebasing the calculation of the transaction costs and cost of carry to this shorter tenor increases the additional costs required to be reflected in future additional borrowing allowances.

In addition, analysis by NatWest Markets[2] ("NWM") has shown that new issue concessions (NIC) have also increased within the gas sector. This increase is being driven by similar factors to those previously outlined surrounding the future of gas and decarbonisation and means that issuers are having to offer greater premiums to incentivise investors to add further gas assets to their portfolios. NWM's analysis shows that the average NIC for issuers in the gas distribution sector was 19bps in 2023 and 10bps in 2024 (as at February 2024). The 2023 average is impacted by two outliers which could, in part, have been driven by idiosyncratic factors, however even with these excluded, the updated average was still above 10, higher than the 0bps Ofgem included within the additional borrowings cost allowance calculation for RIIO-2. Therefore, we would like Ofgem to factor in the gas-specific factors which are already impacting borrowing costs and increase the allowance to sufficiently reflect these higher costs.

[1] Supporting Consultancy work - Report reference FA1
[2] Supporting Consultancy work - Report reference FA11

3

Allowed Return on Equity

Allowed Return on Equity

Key message

Setting an appropriate Cost of Equity for the notional company is an essential part of financeability and investability, and in consequence delivery of services and a safe and reliable service to customers at an efficient cost.

Macroeconomic conditions have changed significantly since the RIIO-2 determination and since the UKRN Guidance was developed. Ofgem needs to adapt its approach to setting allowed returns to reflect this new reality, thereby safeguarding the investability of the sector.

Market evidence shows that rolling forward Ofgem's RIIO-2 approach would determine a range and point estimate that is too low – such a price control would not be investable.

Our advisors have re-run the cross checks relied upon by Ofgem during the RIIO-2 process which points to a significantly higher requirement than implied by CAPM estimates. This evidence, along with new evidence provided on additional cross checks such as hybrid debt costs supports our views that the required returns are increasing.

Evidence previously used by regulators to lower their estimates of the Total Market Return ("TMR") in an era of cheap money have now reversed. The TMR needs to flex upwards, consistent with UKRN guidance and signalling to the markets that allowed returns will be fair over time.

The comparator set for beta estimation used by UK regulators is too limited given the strategic pivot from National Grid away from the gas sector in light of net zero risks. European comparators and debt market cross checks point to a premium being applied today that needs to be included in the assessment of an appropriate cost of capital.

When calculating a real Risk Free Rate ("RFR"), care needs to be taken when deflating as a result of there being no CPI(H) forecast. The wedge between CPI and CPI(H) should be factored into Ofgem's calculation of the risk free rate; along with considering our evidence on how to infer an appropriate RFR.

Regulators internationally have used a wide range of tools to compensate for the risk of asset stranding including an uplift to the cost of capital. In absence of government support to the gas networks to mitigate the aysmetric risk of under-recovery of the allowed income, investors are exposed to the downside. It is clear in our evidence that these risks are being priced in today and should be compensated for.

FQ6. Do stakeholders agree with our interpretation and proposed application of UKRN Recommendations 2-7?

The allowed returns to equity need to increase reflecting the higher risk in our sector and the macro-economic change since RIIO-2 that point to the need to increase the TMR

Our view is the risks facing the gas sector are both higher in RIIO-3 than in previous price controls, and higher than those seen in other sectors regulated by Ofgem. The ENA has submitted a response and accompanying reports from Oxera[1] and Frontier Economics[2],[3] that we support. We don't replicate the evidence provided on the Risk-Free Rate, Total Market Return, Beta (across the sectors) and cross checks here; but append the reports to this submission, which indicate a higher cost of equity across the energy sector. We welcome ongoing discussion up to the SSMD and beyond with Ofgem and our advisors to ensure that this evidence is appropriately taken into account when setting the cost of equity.

We have commissioned Oxera[4] to build on the work they have completed for the ENA and focus on the risks and investability of the GB gas distribution sector. They have observed market evidence supporting the existence of higher risk in the gas networks than other utilities. Although revenue acceleration measures may reduce this perceived risk it can't be eliminated in absence of government support. We comment on this further below. This negative asymmetric risk should be compensated for within the CAPM framework.

The evidence supporting the "gas premium" is shown through a widening of credit spreads. We also provide a report from KPMG[5] that supporting this position.

We ask that Ofgem take into account these pieces of evidence when calibrating CAPM.

The beta estimate should include a premium for gas risks and this can be validated through appropriate analysis of European comparators and the observable cost of debt

The UKRN guidance suggests estimating equity betas for the notional company using comparable listed companies and standard regression techniques (i.e. ordinary least squares (OLS). In RIIO-3, Ofgem have indicated a similar sample of comparators to RIIO-2 will be considered, however the only listed energy network is National Grid (NG) and it has historically included a mix of gas and electricity (and GB and US) assets, although the composition of the mix has changed over time with the restructuring of its portfolio to reduce its exposure to gas. Accordingly, analysis of historical betas for listed UK networks will not provide reliable evidence about GB gas-sector risks, especially on a forward-looking basis as NG has significantly reduced its ownership of gas assets. As such, if the NG beta is to be used, more weight should be applied to the 10-year window which contains the gas specific risks when Cadent was a part of their asset portfolio. This should then be adjusted upwards for the forward-looking gas specific risks highlighted by Oxera.

[1] Supporting Consultancy work – Report reference FA2
[2] Supporting Consultancy work – Report reference FA3
[3] Supporting Consultancy work – Report reference FA4
[4] Supporting Consultancy work – Report reference FA8
[5] Supporting Consultancy work – Report reference FA6

The Oxera[1] report appended shows that the Beta is higher for gas networks than electricity networks, when appropriate European comparators are analysed. There is also an observable gas premium based on credit spreads in the debt markets; and by extension, this implies a higher asset risk and cost of equity. They also observe asymmetric downside risk of revenue recovery. Without a clear and unambiguous commitment from Ofgem and the Government on RAV recovery, there may be an investor perception that the allowed revenues that we are entitled to recover may be at risk. This cannot be fully mitigated through revenue acceleration measures.

Ofgem should continue to use cross checks to assess whether the calculated cost of equity is consistent with market reference points

The ENA has provided a report on Cross Checks from Frontier Economics[2] and Oxera's report on the RIIO-3 Cost of Equity provides detailed analysis of a further cross check on comparing Asset Risk Premiums to Debt Risk Premiums.

In line with our RIIO-2 SSMC response, Cadent continues to support the use of cross checks to calibrate and legitimise the CAPM based cost of equity; as long as the evidence is considered in an objective and balanced way.

Updating the cross checks Ofgem utilised in RIIO-2 using the latest available data strongly indicates an increase in the cost of equity required. The evidence from our advisors points to this being true across all of the cross checks and directionally we agree that the cost of equity by inference must increase.

FQ7. Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 2-7?

The UKRN cost of capital guidance was prepared in a very different economic environment where interest rates were very low. Ofgem will need to adapt its regulatory financial policies and decisions to recognise the very different circumstances under which networks will need to retain and attract capital during RIIO-3. Care needs to be taken in light of the change in macro environment and net zero challenges. Refer to FQ6 for further details.

FQ8. Do stakeholders agree with our proposed methodologies where not specifically covered by the UKRN Guidance recommendations or our approach in previous price controls, such as the proposed approach to converting the RPI-real yields to CPIH-real inputs in the RFR calculation?

We refer Ofgem to the ENA's response submitted on behalf of the energy networks which we support.

[1] Supporting Consultancy work - Report reference FA8
[2] Supporting Consultancy work - Report reference FA3

FQ9. What comparators and/or timeframes are likely to provide the most accurate estimate of beta for the energy network sectors on a forward-looking basis?

As stated in FQ6 in response to UKRN recommendation 5 on Equity Beta, we do not believe the current sample of comparators provide a robust representation of comparable companies.

In RIIO-2, NG's asset beta weighting was 70%, but given the composition of its gas assets has significantly reduced, analysis of historical betas for listed UK networks will not provide reliable evidence about UK gas-sector risks, which is supported by Oxera's[1] report.

Further, the current sample of comparators include a number of UK water networks, but the purpose of asset beta is to capture asset risk. The risks across UK water and energy networks do vary but UK water networks are still included within the sample of comparators.

Therefore, we believe it would be appropriate to consider evidence from European comparators to help calibrate an appropriate uplift to the UK sample.

In the Oxera[2] report commissioned by the Gas Distribution networks, they have considered the evidence on five listed European energy network comparators to the sample: Enagas, Italgas, Red Eléctrica, Snam and Terna. Figures 3.1-3.3 within the report shows on average, the two-, five- and ten-year asset betas of gas networks have been higher than betas of electricity networks since at least early 2019, reflecting a perceived increased risk of gas networks relative to electricity networks. This supports the hypothesis that there are systematic elements in the evolution of gas-specific risks.

Ofgem will need to take extra care when choosing a beta estimate for RIIO-3. Many of the shorter estimation windows are likely to be affected by estimation issues and there have been periods of high market volatility, which are too significant to ignore. As per Frontier Economics[3], following the COVID-19 crisis and the Ukraine war, there is a wide spread sense that global investment risks have heightened. In addition to macroeconomic events, tight supply chains and inflationary pressures are bringing heightened cost volatility and delivery risks at a time when we are supporting the challenge of achieving net zero. One would therefore expect this higher risk environment to translate into higher levels of absolute risk, that would then be reflected in beta estimates.

This changing landscape for gas networks linked to uncertainty over future pathways adds to this risk and points to a requirement to a higher beta on a forward-looking basis.

As part of the Sector Specific Methodology Decision, we request that Ofgem remains flexible and open to hearing evidence relative to beta estimation in light of the changing risk dynamics. We would like to work with Ofgem to agree an approach to including this evidence within the RIIO-3 allowed equity return.

[1] Supporting Consultancy work - Report reference FA2
[2] Supporting Consultancy work - Report reference FA8
[3] Supporting Consultancy work - Report reference FA4

4

Allowed WACC

Allowed WACC

Key message

Our advisors provide details of where we are aligned on the UKRN guidance through their reports. Care is needed in implementation to ensure consistency of approach between how actual and notional companies are financed.
Stability and transparency of decisions and assumptions are key to maintain the strength of the regulatory environment.

FQ10. Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 1 and 9?

Our advisors provide details of where we are aligned on the UKRN guidance through their reports. Where there is agreement, care is needed in their implementation. For example, notional companies need to reflect the costs efficiently incurred in actual company financing structures and these may include derivatives. Regulators should be consistent in their application of notional company assumptions.

FQ11. Do stakeholders consider there to be good reasons to deviate from the notional gearing assumptions (with respect to the level of gearing and the mix of debt types) applied to GD, GT and ET companies in the RIIO-2 price controls?

Significant departures from previous practice should be avoided, as these can create real world implications for companies, for instance where protective debt and pension covenants are linked to notional gearing levels; or managing large changes in gearing to maintain alignment between notional and actual structures.

Notional gearing should remain broadly stable over time and the GD sector has recently experience a significant change from 65% in RIIO-1 to 60% in RIIO-2. Maintaining consistency across price controls is important. Given this recent and large change, we would not see the need to change this assumption in RIIO-3.

FQ12. Do stakeholders agree with the proposal that notional gearing levels should be maintained for each year of the price control? Do stakeholders have a preference for how this assumption is managed within the price control process?

We agree with the proposal and believe it can be relatively implemented using existing mechanisms and as part of the update to the licence for RIIO-3.

Financeability

5

Financeability

Key message

Ofgem has a duty to ensure that network companies are financeable. In fulfilling this duty, we consider that Ofgem must ensure that the long-term financial profile of the notional company is able to support stable and strong credit ratings, and that the framework delivers sufficient headroom for networks to adequately absorb risk.

It is important that Ofgem's approach to financeability of debt emulates how this is assessment is undertaken by rating agencies in the real world, and that a long-term perspective is also taken. Given the potential for significant changes in RIIO-3, Ofgem should consult with rating agencies to understand if target metrics will be changing considering changes to the framework. We would expect rating agencies to "see through" any cashflow benefits that result from revenue acceleration measures and as such target metrics will need to increase. Our report from KPMG[1] on CRAs views supports this position.

We welcome Ofgem including the notion of Investability into the framework and provide evidence through the ENA and a report from Oxera[2] that explains our position in relation to investability. In light of the uncertainties surrounding future gas demand, it is key that the gas networks can attract and retain capital to ensure safe and resilient networks, support an orderly transition to a decarbonised energy system and remain competitive to attract international capital.

FQ13. What, if any, improvements should Ofgem make to the assessment of financeability in the next price control?

It is essential that Ofgem complete a thorough financeability assessment using a transparent methodology such as credit rating agency metrics. We have provided input and support the ENA response relative to ensuring a robust financeability assessment.

Certain financial parameters that could be changed in the RIIO-3 process, such as further accelerating depreciation or a nominal return on debt, may impact target credit ratios used in assessing the financial component of a credit rating. We think it is necessary for Ofgem to consult with rating agencies to understand if they will be adjusting their target metrics to reflect this new reality. To be prudent, Ofgem should expect rating agencies to "see through" any revenues enhancements in their assessment of credit ratings. We refer Ofgem to our report from CRA's[3].

For RIIO-3 we would welcome the additional consideration of a longer-term assessment on financial metrics considering potential for changes to indexation of the RAV and depreciation / capitalisation rate policies. As noted in subsequent responses, reducing the RAV and equity buffer adds pressure to the financial resilience of networks and implies a higher business risk.

[1] Supporting Consultancy work - Report reference FA5
[2] Supporting Consultancy work - Report reference FA8
[3] Supporting Consultancy work - Report reference FA5

When assessing equity financeability, other than the CAPM and cross checks discussed above, it is important to consider an appropriate dividend yield; specific to the situation of the networks. Where networks are returning RAV to investors (i.e. through accelerated depreciation), then the transmission mechanism of this cashflow is through a higher dividend yield. This is specific to the infrastructure investor and the sector dynamic. As such this assumption should be benchmarked appropriately.

We have seen significant macro volatility in RIIO-2 that was not anticipated as part of the stress tests. Stress tests should be suitably challenging to withstand macro and cost shocks based on the evidence of recent events.

FQ14. What evidence, if any, should Ofgem consider in relation to expanding its assessment of financeability to account for 'investability'?

We welcome Ofgem introducing the notion of investability into the framework and believe it has potential to capture investor concerns and ensure the framework is calibrated well for investors, along with maintaining consumer interests. We highlight the ENA response which provides detailed response in relation to FQ14 with supporting evidence provided by our advisors Frontier Economics[1].

We also provide a report from Oxera[2] ("*Risks and Investability of the GB Gas Distribution Sector*") focusing on our sector specific investability position.

From a gas sector perspective investability of gas networks is key to ensuring the resilience of gas network companies and assets and **an orderly transition to a decarbonised energy system**.

Maintaining investor confidence is pertinent across the regulated utilities, meaning that gas investability is likely to have implications for investability of other energy infrastructure assets as well. The **gas sector needs to be competitive in its requirements for capital**. We provide evidence of how international regulators have faced into these risks in the gas sector including through elevating the allowed WACC.

The retention of equity capital, and attraction of new finance for the continuing investment and maintenance of a safe and reliable gas supply, as well as facilitating the transition to no- or low-carbon gas distribution, will be vital for RIIO-GD3, and beyond. For the sector to be investable, we need confidence that equity retained or injected into the business is being remunerated in accordance with the risks that it faces.

Financial resilience and investability are interdependent concepts. Knowing that the network is able to attract and retain investment enables its financial resilience. Without investable business plans, the operational and financial resilience of the sector could be at risk.

It is reasonable to assume that frameworks and decisions developed for GDNs in RIIO-3 will inform investor expectations across new areas of energy regulation (by example hydrogen

[1] Supporting Consultancy work - Report reference FA3
[2] Supporting Consultancy work - Report reference FA8

transportation and CCUS business models), thereby any contagion effects and interdependence of the perceived risks to investability in the gas sector, have the potential to ‘spill over’ across time.

6

Financial Resilience

Financial resilience

Key message

We are very aware of the perception that financing policy has contributed to some of the resilience issues in the water sector in the UK. We acknowledge this, however, the problems seen in the water sector are not evident in energy and so there is no reason to believe that the model applied in the water sector is appropriate or the regulation is stronger. Ofgem already has the tools to deploy should the currently strong financial resilience of networks not continue. Maintaining the resilience of network through allowing an appropriate level of investment underpins the financial resilience of the sector.

We believe the existing financial resilience protections have worked well in the past for the energy sector and ensure an efficient level of financial resilience, so we do not feel any strengthening is required. There is a high hurdle for introducing new regulation to avoid introducing distortions, additional costs and creating other unintended consequences. We are strongly of the view that imposing lock-up provisions or dividend controls would not benefit consumers and regulators should overly rely on credit rating agency views on rating.

Ofgem already has in place a very comprehensive suite of obligations and mechanisms to manage financing, financial resilience and dividend distributions. These include board level obligations, responsibilities for companies' auditors and financial resilience reporting requirements that impose additional requirements on any companies that fail to meet certain resilience criteria.

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

Our Annual report and Accounts are fully compliant with the Wates principles for large private companies Corporate Governance and we provide enhanced disclosures in our RFPR.

Further details of the comprehensive obligations that are currently in place are provided in Table 6.1 further below and we provided details in our response to the Inflation Call for Input as to the existing reporting and protections in place.

FQ15. What is your view on the proposed financial resilience measures? Are these appropriate and/or are there any other measures that you would propose?

Ofgem has significant powers and provisions to maintain scrutiny over the networks and their financial resilience. The measures proposed could increase costs to the consumer without any material incremental benefit. The potential for consumer detriment includes:

- **Restricted ability to adopt the optimal capital structure and increase in the cost of capital** – regulation of distributions and ratings will mean that in some circumstances some companies will not be able to choose their optimal capital structure. The optimal leverage is the result of all the relevant effects including taxes. This means that the cost of capital will increase by definition.

- **Introduction of new regulatory covenants affecting allocation of value across debt and equity** – the proposals are equivalent to additional covenants but imposed by the regulator. As proposed the regulation will potentially enhance credit rights – but at the cost of equity. A forced re-allocation by regulation of risk and cash flow rights in different scenarios between debt and equity providers must be costly to the extent in departs from a market outcome.

- **The rationale for introduction of a cash lock-up appears to be to prevent the use of cash for prohibited purposes** (e.g. the payment of dividends) in circumstances of weakened financial resilience. However, financial resilience is not improved by restricting the uses of cash and may ultimately reduce financial resilience. In particular the introduction of a cash lock-up requirement may deter equity investors from committing capital within the regulatory ringfence, thereby reducing the pool of available equity capital.

The table below summarises the existing provisions within the licence that have worked well to date. The report by KPMG[1] appended to this submission summarises the strong credit ratings within the sector, supported by Ofgem's regulation and stable capital structures.

[1] Supporting Consultancy work - Report reference FA5

Table 6.1 Current Obligations

Obligation	Overview of requirement*	Relevant RIIO2-GD2 licence condition reference
Credit Rating	Licensee must take all appropriate steps to ensure that it maintains an investment grade credit rating. Includes financial resilience reporting for some sectors.	SSC A38
Availability of Resources	Board of directors evaluates any proposed dividend payment and certify that the making of that payment itself, or when it is taken with other reasonably foreseeable circumstances, will not cause the licensee to be in material breach of the specified licence conditions; and Certify that the licensee's directors have a reasonable expectation that the licensee will have sufficient financial resources and financial facilities and operational resources respectively to enable the licensee to carry on the Distribution/ Transmission Business for a period of 12 months from the date of the relevant certificate.	SSC A37
Pre dividend certificate of compliance	Directors formally certify that the licensee is compliant with a wide range of relevant obligations and that the making of a distribution would not cause it to become non-compliant.	SSC A37
Indebtedness	Restricts the type of financial transactions and arrangements that licensees can enter into.	SSC A39
Restriction of Activity and Financial Ring Fencing	Restricts the activities that the licensee can undertake, including investment activities. Requires that a licensee has in force a system of treasury management operations internal controls that complies with best corporate governance practice.	SSC A36
Prohibition of Cross Subsidies	Prohibits any cross subsidy between the licensee and any other activity or company in the same ownership group.	SSC A35
Undertaking from the Ultimate Controller	Requires commitment from the holding company that owns a licensee that it and other companies in the same ownership group will refrain from action that would be likely to cause the licensee to breach any of its obligations under the Act or this licence.	SSC A26
Regulatory financial performance reporting (RFPR)	RFPR requires considerable reporting related to dividends and dividend decisions including: • the level of any dividends; • a reconciliation to statutory accounts; • a split of regulated and non-regulated business dividends; • an explanation of approach to dividends; • details of where decisions reside for dividend policy; and • an explanation of dividend policies and consideration of long-term financial sustainability	SSC A40

Taking each of the proposed financial resilience measures in turn, we provide our comments below:

Amend licence condition to "require" licensees to maintain more than one investment grade rating rather than "use reasonable endeavours" or "all appropriate steps"

We do not believe mandating licensees to maintain more than one investment grade rating is required or appropriate. It is not reasonable to place an obligation on networks where many aspects to the obligation that are out of management control, e.g. a changing regulatory environment and the views of the rating agencies on those changes and any uncertainty this creates. This is particularly relevant for the gas sector as we move towards Net Zero.

In assessing credit ratings, for Fitch specifically, Ofgem should consider the senior debt rating in Fitch's methodology as the more appropriate rating to monitor rather than the issuer default rating. Fitch note in their recent report on the SSMC for RIIO-3 that this is a better comparison to the ratings of other agencies and factors in recovery considerations.

Given the strength of credit ratings in the sector, there is no clear case for change.

Amend the dividend lock-up trigger to be the earlier of reaching BBB- with a negative watch/outlook and 80% regulatory gearing

As noted above, linking licence provisions credit ratings could have unintended consequences as management and Ofgem are not able to control for the opinions of rating agencies which will vary over time.

Cadent has more than one strong investment grade rating and has significant headroom to the 80% regulatory gearing threshold. However, as noted by Fitch in their recent report on the SSMC, these additional provisions will not have any material consequence in practice.

As noted above, we disagree that there is customer benefit from placing a dividend lock up provision in the licence and see that this could add costs to customers in the longer term, with existing provisions providing sufficient protection.

Amend the Availability of Resources requirement for board certification to require that the licensee states that, based on agreed assumptions, it has sufficient financial resources to cover the entire price control period or a minimum of three years ahead.

Extending the Availability of Resources requirements could add costs to customer and not be in their interests. Depending on how this change is implemented, it could add financing costs to secure financial resources and provide assurance to Boards on compliance. We understand from the working groups held with Ofgem that the intention is not to increase the cost to customers, and we welcome this. We will consider the detail of any proposals and will work with Ofgem to ensure that the agreed assumptions align to this intent.

FQ16. Are there better ways to protect against excessive leverage and financial risks, in particular leverage via acquisition finance, by utilising existing powers rather than imposing new requirements in the licence?

As discussed above, we believe the existing financial resilience protections are strong and sufficient. There is a long track record of the existing measures being successful.

FQ17. For the SSMC we have not proposed dividend controls or dividend policy requirements. How should we think about protections to ensure that leverage at MidCo and/or HoldCo does not become disproportionately influential in decision making at the licensee with the potential for negative outcomes for consumers?

We agree that dividend controls are not required.

Given the highly securitised nature of our group and financing structure, there are significant restrictions already in place that prevent leverage above the operating company having a disproportionate impact on the ring-fenced business. Combined with the many existing protections in place as noted above, we do not believe further controls are required.

We support providing transparency of the MidCo / HoldCo structures to support Ofgem's understanding of the risks contained. As noted, we provide significant disclosure in our RFPR, and annual report and accounts.

FQ18. Is there merit in amending the RFPR RIGs to include requirements for Licensees to undertake stress-testing, and to provide the results to Ofgem, as in the Retail sector and as the Prudential Regulatory Authority / Bank of England does for banks, to test for financial resilience?

As discussed above, we believe the existing financial resilience protections are strong and sufficient and evidenced by the strong credit metrics in the sector and track record on financial resilience through what has been quite exceptional times in the sector over the last 5 years.

We complete significant stress testing as part of good corporate governance but also for the various obligations imposed by the Companies Act, our licence and auditing standards.

Adding a requirement to provide results to Ofgem will add additional costs to customers which as noted above is not in consumers interests.

We welcome providing increased transparency of the MidCo / HoldCo structures to support Ofgem's understanding of the risks contained. We will continue to engage with Ofgem through the RFPR RIGs consultation that we understand will be run in parallel to the SSMC response process.

7

Corporation Tax

Corporation Tax

Key message

We agree with maintaining the notional company allowance and provide comments as to how the current implementation of this approach could be improved in light of legislative changes and lessons learned during the RIIO-2 control.

FQ19. Do you agree with our proposal to align the RIIO-3 tax approach with RIIO-2 and ED2 including; to maintain Option A - notional allowance with added protections; the approach to capital allowances, and "glide path"?

We agree to maintain option A notional allowance with added protections; but highlight the below:

- With respect to capital allowances in RIIO-2 as detailed in para 7.4, we propose that in addition to writing down allowances ("WDAs") the capital allowances should include first year allowances ("FYAs"). Then the allocation to the pools qualifying for FYAs and pools qualifying for WDAs and the rates applied to each can be included as variable values to enable updates during the price control. This would enable the inclusion of changes to FYAs on 100% expensing and any other changes made in the RIIO 3 period for FYAs as well as those made to WDAs and corporation tax rates.

- With respect to added protections tax allowance adjustment ('TaxAt) as detailed in para 7.3. As a supportive measure, two additional protections were introduced namely 'Tax reconciliation' and 'Board assurance statement' which required licensees to submit an annual tax reconciliation between the notional allowance and actual tax liability accompanied with an assurance from the board over the appropriateness of the values in the reconciliation, as an enabler for Ofgem to trigger a formal tax review as necessary.

    i) Special licence condition 2.2 states Ofgem may undertake a review of "material, unexplained differences between the licensee's Calculated Tax Allowance and its Actual Corporation Tax Liability" in accordance with Chapter 6 of the GD2 Price Control Financial Handbook. This should be replicated in RIIO 3 to replace the proposed current wording in consultation document which states "The purpose of this mechanism is to adjust a licensee's tax allowance, if needed, as part of an annual review and update of the Allowed Revenue (ARt) during the Annual Iteration Process (AIP). The mechanism serves in the best interest of the consumers and is in line with the principal statutory objectives of Ofgem, ensuring that licensees do not benefit from undue financial gains if their actual tax liability is materially different from the notional tax Allowance.

    ii) The tax reconciliation and board assurance – table R8a is still not finalised so no board assurance was provided in September as agreed with Ofgem. We will work with Ofgem on a process to consider changes to the statement that would form the basis of the board assurance and a potential TaxAt adjustment.

FQ20. Do you agree with the proposed revision to tax clawback methodology?

We believe Ofgem should apply consistency across the price control. Where derivatives are used to effectively manage inflation risk, these should be allowed for across all aspects of the framework.

Regulatory Depreciation and Economic Asset Lives

8

Regulatory Depreciation and Economic Asset Lives

Key message

We welcome Ofgem focusing on the issue of the potential for asset stranding in the gas sector in light of its net zero commitment. We agree that it is not in the interests of consumers for investors to be at risk of under-recovery of the RAV.

We do not believe action needs to be taken now to further accelerate depreciation given the uncertainty over future pathways for decarbonisation and extent to which assets will be repurposed. If any action is proposed, we suggest that this is done in small steps; perhaps focused more on new investment depreciation profiles; and not aligned to Future Energy Scenario's which are inherently uncertain and may send out market signals that increase costs to consumers. In the absence of an unambiguous commitment from the government over RAV and revenue recovery, networks maintain the asymmetric risk of recovering income due and this needs to be compensated for.

The gas networks will be required to support a resilient energy infrastructure for decades to come, enabling a smooth transition to a lower carbon economy. As such, any significant change in RAV depreciation or asset capitalisation policy would be inappropriate, as it would create the very real risk of discouraging network investment, reducing innovation and undermining investor confidence to provide long-term capital, in addition to adversely impacting company financeability and investability.

We agree it will be important to set the framework to ensure investor recovery of current RAV and how repurposing rules and additional decommissioning costs should be recovered. However, these issues will need a lot of careful development and we propose Ofgem take the necessary time to explore and develop these against a range of potential cases of consumer led or strategically planned energy transitions. We also recognise that aspects of this framework would not fall within Ofgem's sole remit, and we advocate for cross sector and government engagement on the issue.

We provide supporting evidence on how other regulators are managing these stranding risks through a report provided by Oxera[1].

FQ21. GD & GT: assuming re-openers are available and there is no adjustment to the allowed WACC, how should regulatory depreciation be used to address the uncertainty around the future path for gas and perceived asset stranding risk?

Summary

[1] Supporting Consultancy work - Report reference FA8

We welcome Ofgem focusing on the issue of the potential for asset stranding in the gas sector in light of its net zero commitment. We agree than it is not in the interests of consumers for investors to be at risk of under-recovery of the RAV.

It is essential that any change in RAV depreciation or asset capitalisation policy does not have unintended consequences such as constraining necessary network investment, reducing innovation, or undermining investor confidence. The gas networks will be required to support a resilient energy infrastructure and enable a smooth transition to a lower carbon economy for decades to come. As such our view is that maintaining the current approach to depreciation is appropriate until there is greater certainty.

To fully resolve the potential for downside risk on asset recovery and avoid risk premia being priced into our cost of capital, we would need to see an unambiguous government commitment to the recoverability of the RAV and allowed revenues. As noted in the SSMC, this is a matter of government policy and as such we welcome working with Ofgem and GDNs to deliver this solution. Up to the point when this "insurance" policy is in place there will remain a risk it is necessary that investors be remunerated to hold, in order to maintain an appropriate balance of risk and reward and to avoid capital leaving the sector.

We provide evidence of how these asymmetric recovery risks have been appropriately calibrated into the allowed return in an international context and why cash profiling can reduce but not eliminate the risk to investors. We refer Ofgem to the report prepared by Oxera[1].

The range of future pathways is uncertain and the risk can't be "regulated" away

The suite of pathways towards and past 2050 is wide-ranging with uncertain probabilities of each of them materialising. However, no matter which one of them plays out, there's no possible opportunity to over-recover income, but a non-zero probability of a downside for investors in gas networks. This has created an asymmetric risk, which is perceived and priced in by investors today, but which is unremunerated within the current framework.

These risks cannot be mitigated through changes to regulatory depreciation alone until there is an agreed framework in place that underpins / "insures" the future RAV recovery. We believe this risk should be remunerated in order to secure investability to attract the critical investment needed in RIIO-3 and beyond. As such we disagree with the assumption that no adjustment to allowed WACC is required. A RAV recovery framework could consider depreciation policy as well as government intervention and wider socialisation of costs currently attributed to gas customers.

We recognise this requires multi-stakeholder involvement and is outside the remit of the price control setting process, but we would encourage Ofgem to work with Government and Licensees to establish a framework for RAV recovery thus mitigating the risk which will ultimately be in the long term interest of consumers. A wider RAV recovery framework could consider depreciation policy and treatment of future decommissioning costs, as well as government intervention and wider socialisation of costs currently attributed to gas customers.

[1] Supporting Consultancy work - Report reference 8

Messaging a change in depreciation policy should be managed cautiously considering our requirement to continue to attract long term capital

We acknowledge that Ofgem are reviewing the regulatory depreciation policy considering the risks highlighted above, however it is important to proceed with caution to avoid unintended consequences.

It is essential that investment in the network is maintained to ensure safe and reliable operations, enhance service performance further and drive forward innovation is not compromised by any potential policy changes.

The gas networks will continue to be used for decades to come and will continue to play a crucial role in a resilient net zero energy infrastructure in the UK and care is needed to prevent adversely affecting investor views on the GD sector. Investors are paying close attention to recent developments, and the way Ofgem positions these issues affects investors' perception of risk.

Ofgem's decisions must not pre-empt significant government policy decisions that will affect the gas networks. This includes ensuring undue weight is not placed on future energy sector scenarios, which themselves include inbuilt assumptions on future energy policy decisions.

Ofgem should consider its RAV recovery policy through the lens of long-term investability and financial resilience of the gas networks

Reducing the RAV balances has long term implications for the financial resilience of networks. Certain costs, including the operating costs of maintaining a safe and reliable network, will remain largely fixed to manage a significant footprint, whilst the equity buffer to manage risk reduces with lower RAV. This means that all other things being equal that there will be a greater exposure to operating risks with lower levels of equity buffer to mitigate these increasing business risks. This could prove costly in the long term to networks and consumers.

Long dated debt within the regulatory model is supported by a long-term regulatory depreciation policy to return the investments made. Creating a mismatch between the maturity of debt and the timing of when RAV is returned to those investors increases the risk profile.

The underlying statutory framework supporting the need for licensees to be able to finance their licensed activities is itself long term and not limited to consideration within a single regulatory cycle or price control period. Therefore, in considering depreciation it is appropriate that Ofgem consider and model the long term financeability impact.

Given the long time periods available, a policy re-opener is not required

In any potential policy, whilst we acknowledge the need for flexibility given uncertainty over future government policy, we believe the current pace of change suggests a re-opener is not required (see FQ23) and instead regulatory depreciation should be reviewed and considered at each price control review, in light of a wider RAV recovery framework.

FQ22. GD & GT: what long-term path should regulatory depreciation aim to follow between 2026 and the assumed de-energisation point to promote fairness for current and future consumers? What unit metrics should this be based on? Is this resilient to the various scenarios under FES 2023?

We support the UK's ambition for Net Zero by 2050 and recognise GEMA's statutory duty to take account of this when making price control decisions. We note that GEMA must also have regard to the Growth Duty and impact of decisions UK jobs and investment of which the gas distribution sector is a key contributor. Promoting fairness between current and future customers requires a full impact assessment the various stakeholder groups who will be impacted. This issue should be considered in light of a wider RAV recovery framework as highlighted in FQ21.

In terms of approach following from this SSMC process, our view is that at this stage, there remains too much uncertainty over long-term pathways to place weight on the scenarios when setting a depreciation policy. Signalling to the market that the gas networks are on a certain trajectory could have adverse consequences.

Determining the unit metrics to apply in setting a policy is a step too far at this point and inconsistent with international precedent. If Ofgem are inclined to amend the policy, we would prefer to see a continuation of the approach taken by Ofgem and other international regulators to amend the lives of assets based on a time period and amortisation profile, rather than linking to uncertain demand forecasts.

Whilst we believe the FES scenarios highlight the potential asset stranding risk, it is important that in any change in policy Ofgem is cautious in its approach and does not place emphasis on a single scenario or set of scenarios which are very highly uncertain and assumption driven.

As highlighted in FQ21, care is needed to prevent adversely affecting investor views on the GD sector. Signalling a proposed pathway and depreciating RAV to zero could undermine the value of the assets for future use cases and send a negative signal to the financial markets who we will continue to seek long term capital from for decades to come, increase costs, and adversely impacting GD customers.

With higher interest rates and inflation, increasing legislative workload requirements, bills will be rising in RIIO-3 even under the current depreciation profile before factoring in the moderate decline in volumes already envisaged under some FES scenarios.

When considering this impact assessment, we recommend that Ofgem calculate a more complete picture of the customer impact than that shared through the SSMC process. By example, we note that profiling historic RAV is only one element feeding into customer bills. To fully analyse the intergenerational impact, the future RAV additions (although uncertain) and other costs that make up the bill for example operating costs need to be considered.

This analysis may point to the need for a wider socialisation of costs which should be considered in an overall revenue and RAV recovery framework, to mitigate risks to investors.

We believe with the quantum of uncertainty and significant time that the UK will be reliant on the gas networks, Ofgem do not need to make any urgent change to the policy but should keep this under review. The existing sum of digits method of depreciation which by definition front loads the depreciation of the RAV closer to when the initial investments take place already reflects a desire to bring capital recovery earlier and charges more to existing customers over future customers.

We would urge caution in making any significant changes to current policy until we have greater certainty over future network requirements.

FQ23. GD & GT: assuming there is a relevant gas reopener for government policy, is there a need to reopen regulatory depreciation policy intra-period?

We do not believe there is a need to reopen the regulatory depreciation policy intra-period. Regulatory depreciation policy is a fundamental building block of the RIIO framework that cannot be disentangled from other aspects of the price control. It requires a detailed financeability and impact assessment which should only be conducted as part of a full price control review process. The impacts of material policy changes should be considered over multiple price control periods. Ofgem should not signal otherwise through inclusion of a re-opener mechanism. Consideration of an amended regulatory depreciation policy at a subsequent price control rather than a within-period re-opener would not materially impact the outcome of any policy change given the very long time periods the networks will be around for.

Having relative certainty over revenues through a price control gives confidence to licensee's to efficiently plan financing requirements. A re-opener on such a key policy would reduce this certainty and may have other unintended consequences. This is especially important in a relatively shorter price control period of 5 years compared to the recent longer controls at RIIO-1.

FQ24. GD & GT: what considerations are raised by asset repurposing and how might these affect the decisions to be made on regulatory depreciation policy? What guidance is sought for the SSMD so that licensees have sufficient clarity for their business plans?

We do not expect our RIIO-GD3 business plan to include any material costs associated with asset decommissioning or repurposing.

However, whilst we do not expect any asset repurposing and/or asset decommissioning during RIIO-GD3, the consideration of how such issues will be managed cannot be delayed. We believe a cross-sector working group including Ofgem, Government and Licensees should be established, sooner rather than later, to discuss the interrelated issues associated with asset repurposing and decommissioning. An early exploration and understanding of the different potential future scenarios under which assets may be repurposed or decommissioned, and the appropriate regulatory framework for managing these processes, will help to maintain investor confidence in all regulated sectors, and inform regulatory policies for depreciation and the recovery of the costs of decommissioning and/or repurposing. For example, in some scenarios, asset repurposing may be centrally-directed, following consideration by the NESO. In other scenarios, GDNs could be incentivised to seek opportunities for re-use of their assets by other sectors or may seek to use their assets as part of an innovation trial.

Given that, in many cases, the decommissioning of assets will be the ultimate long-term counterfactual to asset repurposing, the regulatory treatment of each cannot be considered in isolation. In order to avoid unintended consequences and to incentivise asset repurposing, where it is in the interests of customers, both decommissioning and repurposing should be considered in tandem.

Given the ongoing uncertainty around future government decisions, we would urge Ofgem to adopt caution in making any firm decisions in this area that may have unintended consequences.

For example, we note that DESNZ has set out its initial view of a Hydrogen Networks Pathway and is currently developing its Hydrogen Transport Business Model (HTBM) design with progress expected by Q2 this year. There is clear potential for gas distribution assets to be repurposed in the future, and an important part of the HTBM design will be to establish a methodology by which asset value is transferred into the HTBM. Ofgem should avoid making any final decisions on depreciation policy pending confirmation of the intended HTBM design.

FQ25. ET: do stakeholders consider there to be a need for amending the existing RIIO-ET2 asset life and/or profile assumptions, on either a company-specific or sector basis? If so, please set out your evidence base and potential consumer benefits and costs of changing the existing methodology?

Our response focuses on requirements of the gas distribution sector.

FQ26. If a ‘semi-nominal’ cost of debt and WACC approach were to be adopted which results in an acceleration of cashflows, would this impact your responses to any of the questions above?

Given the quantum of change being considered for the gas distribution sector, we advise focusing on the correct RAV depreciation policy to mitigate stranded RAV risks. The semi-nominal WACC approach has significant implementation risk given it would be novel and untested. When considered with the wider changes being considered for funding debt costs adds another layer of complexity that should be avoided.

Given the potential impact on customer bills of changing the RAV depreciation policy, Ofgem should be cautious about adding incremental costs to current customers without completing a full impact assessment.

9

Return Adjustment Mechanisms (RAMs)

Return Adjustment Mechanisms (RAMs)

Key message

We continue to advocate for the use of RAMs and believe they have a role to play in enhancing customer confidence in returns earned by utilities whilst ensuring an appropriate backstop to downside risk.

The RAM should be based on a holistic view of the framework and risks contained therein. There is potential to further tighten the RAM subject to appropriate calibration which might give Ofgem more confidence to offer better financial incentives that drive great outcomes for our customers whilst managing the overall share of rewards between networks and customers .

FQ27. Do stakeholders have views or evidence as to why RAMs should or should not continue?

We agree that RAMs should continue in RIIO-3.

Given the challenge of meeting Net Zero there is a critical need for positive public engagement with the energy transition. However, our Customer Focus Groups have shown that public / customer confidence in the energy industry as a whole is low. Whilst this lack of confidence is predominantly focused on energy retail and the framework that governs this market, it remains critical that customers have confidence in network companies to deliver the infrastructure needed for the energy transition. The use of RAMs can support this.

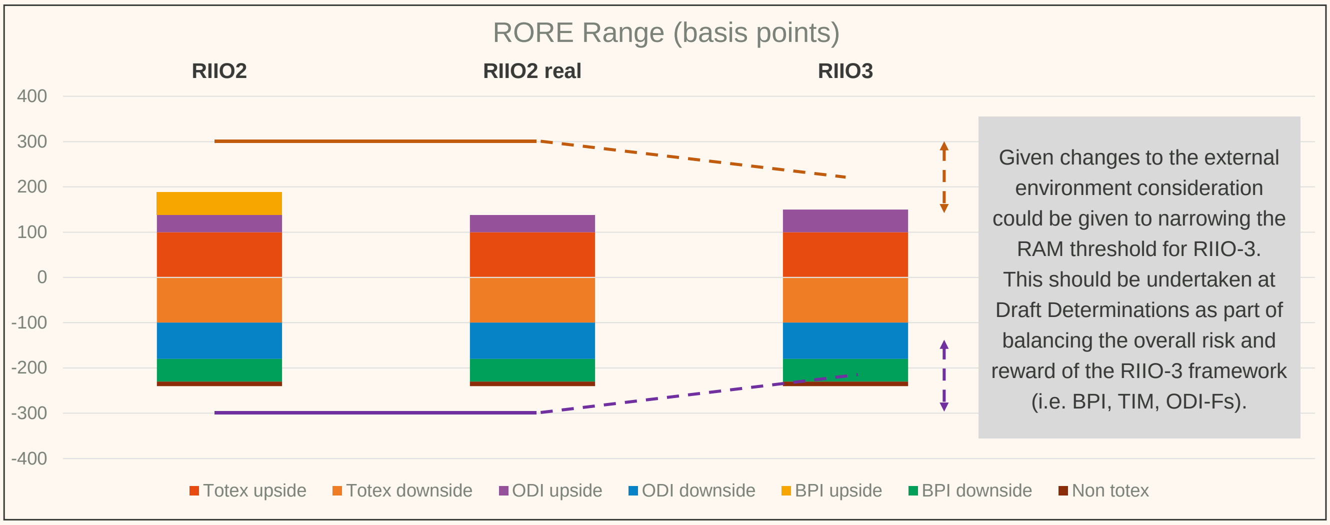
The use of RAMs is also supported by the macroeconomic environment, financial volatility and step change in input costs seen in RIIO-2. It would also recognise the experiences seen in other utility industries in recent years where financial distress is undermining confidence in not only companies but also the regulatory regime.

FQ28. Do stakeholders have views or evidence as to whether the RAMs methodology should be amended, such as recalibrating the threshold or rates or including financial performance?

The RAM should be set as part of the holistic risk/reward incentive framework for RIIO-3 including the Cost of capital, Business Plan Incentive (BPI), Totex Incentive Mechanism (TIM) and Financial Output Delivery Incentives (ODI-F). As such, the RAM thresholds and rates should be kept under review and set based on what is needed from network companies as well as the overall risks and opportunities they face within the control period.

In RIIO-2 the RAM was broadly set to ensure on the lower side that companies would have protection around the cost of debt. Clearly the environment has changed significantly during RIIO-2, with significant increases in the cost of debt observed, so careful consideration will be needed in how the lower threshold is set for RIIO-3.

In RIIO-GD2 the upside incentive package was heavily constrained. This appeared to be for a variety of reasons. On financial ODIs, it appeared that as GDN performance had been strong, incentives were predominantly used to lock this good performance in. On the Quality elements of the BPI it appeared that Ofgem did not have the confidence in the mechanism to enable them to make any material rewards at the upfront stage. This also appeared to be the case in RIIO-GD1 where no GDNs were fast tracked. In RIIO-3 our customer and stakeholder insight is highlighting some opportunities for where greater positive incentives will be valuable to customers to drive the industry behavioural change, coordination, innovation and ambition that is going to be needed to deliver the energy transition. Given the changing environment on the upper and lower side of the risk/reward range we recommend the RAM thresholds are reviewed in light of decisions around the wider framework and could be narrowed to ensure that customers and networks are insulated from the risks of miscalibration of the framework. This would give Ofgem the flexibility to explore new output incentives for customers and to protect from cost and financial volatility.



FQ29. Do stakeholders have views or evidence as to whether there should be separate RAMs for 'BAU' parts of the business and specific programmes, such as ASTI?

Large strategic programmes of work, such as those delivered under the Accelerated Strategic Transmission Investment (ASTI) regime, should be excluded from a ‘Business As Usual’ Return Adjustment Mechanism (RAM). These large value strategic programmes of work could have a disproportionate impact on the RAM and should include their own mechanisms to protect customers and companies from material deviations from expected spend.

10

Other finance issues

Other Finance Issues

Key message

We would prefer to see simplicity in approach to capitalisation rates ensuring a flexibility to enable a fair allocation between fast and slow money that mirrors the accounting treatment and avoids a mismatch and a consequential impact on credit metrics that was not expected at the point of the financeability assessment. We ask Ofgem to include as a variable value the capitalisation rate for material and uncertain reopeners.

We have two suggestions to improve the resilience of the Price Control Financial Model. Amending the adjustment term ("Adj") to avoid single year charging shocks as a consequence of volatility in inflation and gas prices by example; and considering aligning the financial years for the National Transmission System ("NTS") to the other transporters to ensure charges are aligned reducing risk of timing differences.

FQ30. Is there a case for altering the capitalisation rate modelling approach between sectors (e.g. removing the multiple bucket approach for GD)?

We agree with Ofgem in trying to deliver consistency and simplification. The principle we apply when considering the models is that we should have the ambition that costs and income should be appropriately matched between regulatory and statutory accounting. This ensures that the financeability assessment undertaken at the beginning of a price control holds through the period.

One concern we have is when setting upfront ex-ante capitalisation rates for large / uncertain reopeners. For example, if ex ante the assumption is a large reopener is funded via slow money, however, the submission for the re-opener assumes significant fast money, it will create a mismatch. This inconsistency creates volatility in our key metrics such as FFO to Net Debt. As such, we ask Ofgem to include as a variable value the capitalisation rate for material and uncertain reopeners.

FQ31. What are your views on retaining an ex-ante capitalisation rate for allowed totex, but reporting an outturn capitalisation rate for the purpose of calculating the totex incentive mechanism?

See FQ30. Our priority is the capitalisation rates for allowances reflect the latest view of spend split between fast and slow money to avoid mismatches, particularly for material and uncertain re-openers.

FQ32. Are there any reasons why the RIIO-3 approach to directly remunerated services should differ from RIIO-2?

We have no major objection to the current approach.

FQ33. Do stakeholders have any reasons or evidence to suggest more directly remunerated service categories are necessary?

We do not anticipate further categories being required in RIIO-3.

FQ34. Do stakeholders have views or evidence in support of or objection to treating all asset disposals as fast money? Would the existing or alternative approaches have greater merit?

The treatment of asset disposals has evolved from a 5-year deferral through a logging up adjustment in RIIO-1, to proceeds being netted off against totex in the year of disposal before a Totex Incentive Mechanism ("TIM") is applied in RIIO-2.

By shifting to asset disposals being treated as fast money, whilst customers would see an immediate benefit, a number of considerations should be taken into account to avoid unintended consequences, for instance:

- This could potentially create more volatility in customer bills and prone to forecast error;
- This could be challenging relative to financeability and could cause constraints relative to credit metrics with significant variations in annual revenues.

As such, we have no major objection to the continuance of the existing RIIO-2 approach.

We do not anticipate significant disposal transactions in RIIO-3. However, in the longer term, it may be both necessary and desirable for elements of the gas distribution network to be repurposed as part of the energy transition. Given the potential scale of such asset repurposing and the associated benefits to customers, the framework for doing so (both in terms of asset transfer values and incentivisation) will need careful thought. Indeed, as we outline in our response to FQ24, we would welcome the opportunity to discuss these issues at an early stage in a broader industry forum to maintain industry and investor confidence and avoid any unintended consequences.

FQ35. Do stakeholders have views or evidence as to what reporting information should be provided to Ofgem (under the RPFRs or other forms) to ensure objective identifiability of repurposed assets and cost data remains appropriately like-for-like?

We understand that, over time, additional information will be required to identify repurposed assets. We do not anticipate any significant repurposing of gas distribution assets during the RIIO-GD3 period, as they will be required to serve our natural gas consumers. As such, we would welcome joining a working group to discuss how best to approach this in RIIO-3 with a view to its implementation in subsequent price controls.

FQ36. Do you consider that the existing reporting requirements on executive pay/remuneration, dividends and corporate governance previously introduced for RIIO-2 price controls remain appropriate in helping demonstrate the legitimacy and transparency of company performance?

We believe the existing reporting requirements are more than sufficient and we go further in our annual report and accounts. By publishing extensive details on executive remuneration, and corporate governance, we are providing stakeholders with the detail to support their understanding of our business. We understand that the reporting requirements under the Regulatory Financial Performance Reporting are being consulted on in the coming months and we will input into the consultation in parallel to the SSMC response.

FQ37. Do you have any other suggestions for clarifying or strengthening the reporting requirements with regard to executive pay/remuneration, dividends or corporate governance?

We do not feel any strengthening is required in light of the enhancements made. We provided details in our response to the Call for Input on inflation in the Autumn of 2023 as to the existing reporting and protections in place.

Please refer to the Financial Resilience section of this response for further details.

FQ38. Do you have any suggestions on how to improve and future-proof the price control financial model, or use cases it could better support?

We welcome that Ofgem are seeking to continually improve the PCFM model and work constructively with networks. Our view is that the current model works and provides good transparency of data to end users, mainly networks, shippers, and credit rating agencies.

We understand the drive to push for further improvement but given that the existing model is well understood and there are a number of potential regulatory changes in RIIO-3, we recommend minimising the change to avoid unintended modelling issues arising.

As usual we highly recommend model audits being completed as part of the Business Plan Financial Model process used for financeability assessment and the final model used to complete the licence drafting to ensure robustness of calculations and conclusions drawn.

We have two improvements that we would like to incorporate in future in support of improved transparency and to enable less volatility in charges. Firstly, the adjustment terms (“Adj”) is a complex calculation that consider a large number of timing differences and incorporates into one licence term. It would support stakeholders to have some analysis included within the PCFM for to consistently disaggregate this term into constituent parts.

Secondly, we have had significant charging volatility in RIIO-2 due to macro changes to gas prices, inflation, tax changes and flow through to NTS charges. For example, the cumulative adjustment term for Cadent as a whole going into FY24/25 is c.£200m. This poses issues relative to cashflow management. As such, we would recommend that the adjustment term can be self-managed to amortise over a short time period (e.g. 2 years) to smooth differences such as this as required. A key driver of the revenue volatility is the knock-on impact of the National Transmission System charging year being inconsistent with the GDNs which can create timing differences. We recommend that Ofgem seeks to align the charging year at the next price control period to drive consistency of approach for shippers and networks.

FQ39. What are your views on allowing licensees to self-publish the PCFM with their charging statements, rather than relying on an Ofgem publication or direction to determine allowed revenue?

We support Ofgem is achieving consistency of approach. We welcome continued engagement on the detail of how this could be implemented.

FQ40. What are your views on applying a single time value of money in the financial model to all prior year adjustments, based on nominal WACC?

Our views have not changed since RIIO-2. We re-submit the paper provided by First Economics[1] and referenced in the SSMC for convenience.

[1] Supporting Consultancy work - Report reference 10

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