

## SGN Response to Specific Finance Annex Questions

### 1. SGN's observations on the SSMC Section 1. Introduction

- 1.1. The UK economy has been through a series of seismic shocks since the RIIO-2 business plan was submitted in December 2019. These include COVID, Brexit, and the resulting supply chain shocks arising from both the supply chain and energy price shocks that have arisen from the Russian invasion of Ukraine and the September 2022 HM Treasury mini budget. These events have resulted in a shift in the global economy from a relatively benign, low inflation, loose monetary policy environment with low interest rates to a very volatile, high inflation environment which, in turn, has led to high interest rates and a tightening of monetary policy. Upcoming elections in the UK and US suggests that the volatility of the last 5 years is likely to remain. These seismic shocks have created a step change in financial expectations.

- 1.3. We welcome the fact that Ofgem has opened the debate on managing these significant macro changes and the resultant uncertainty. The debate must occur in a timely and considered manner. Specifically, we welcome the fact that Ofgem has identified that the two macro-economic challenges of declining gas demand and investability require a review of how the regulatory finance toolkit is utilised. However, the SSMC does not link the two for gas. For example, we strongly disagree with the characterisation of investability as only being a consideration for Electricity Transmission (ET) and with the definition proposed that investability is determined by the expectation of network companies to seek fresh equity over and above what they would be able to fund via retained earnings<sup>6</sup>.

- 1.5. In our view, evidence supports that investability is a material challenge for gas given the future uncertainty in the role of gas networks. This uncertainty is highlighted through the FES scenarios. The forecast under the 'Leading the Way Scenario' is that domestic gas demand will have fallen by 40% from 2021 levels by

<sup>1</sup> [Future Energy Scenarios \(FES\) | ESO \(nationalgrideso.com\)](#)

<sup>2</sup> [Consultation on frameworks for future systems and network regulation: enabling an energy system for the future \(ofgem.gov.uk\)](#), para 2.12.

<sup>3</sup> [RIIO-3 Sector Specific Methodology for the Gas Distribution Gas Transmission and Electricity Transmission Sectors | Ofgem](#)

<sup>4</sup> [Technical annex - Hydrogen heating - NIC](#)

<sup>5</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 1.2.

<sup>6</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#) para 1.5 and 1.6.

- 1.6. Investment costs are largely determined by the km of pipelines transporting gas and the need to operate that network safely. Therefore, as a gas network, we will need to continue to incur significant levels of investment and fixed running costs for many years to come. We have a legal duty to supply our customers safely and reliably; this will require continued investment in the network for as long as there are customers using gas. It is only once the last customer has migrated away from the gas networks that we can de-energise that section of network and reduce ongoing investment and operating costs.
- 1.7. If the FES scenario 'Leading the Way' is realised it will create a widening financial gap between the level of investment and fixed costs required, and the potential number of customers from which to recover the costs, which translates into an asset stranding and cost recovery risk. If gas networks are to be phased out, this financial gap needs to be addressed.
- 1.8. However, the likelihood of realising the FES 'Leading the Way' scenario is very low. Current market evidence shows that customers are not migrating away from the gas network voluntarily. In 2024, a total of 17,156 vouchers were issued for the boiler upgrade scheme to install heat pumps, if all are installed, this is approximately 18%<sup>8</sup> of the installation rate forecast by FES's Leading the Way scenario<sup>9</sup> and less than 0.5% of the forecast installation rate in the first year of RIIO-3, 2026.
- 1.9. This disconnect between ambition (policy) and reality (the delivery plan) creates an increasing risk for operators of gas networks.

[REDACTED]

15 Future Energy Scenarios (FES) | ESO ([nationalgrideso.com](http://nationalgrideso.com))

the network. There is a legal requirement to maintain the safety of the public until the network can be de-energised (i.e., the last customer has disconnected) irrespective of policy and FES scenarios.

1.11. We welcome the position Ofgem has taken that there is a need to avoid creating an asset stranding risk for Gas Networks and that costs should be recouped from current and future customers<sup>16</sup>. However, we note that the proposed solution of accelerated depreciation is the only solution within the regulatory toolkit, and other solutions are potentially ultra-vires for Ofgem at this stage. It is our view that this limits Ofgem's, and the SSMC's, ability to address the problem at hand. Operating within these constraints risks sub-optimal decision making and a disregard of options that may be more beneficial, or required, in the future. It is incumbent on Ofgem to consider all options, whether or not within its existing vires, before reaching a conclusion on the appropriate cost recovery model to apply. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

<sup>16</sup> RIIO-3 Sector Specific Methodology Consultation: [RIIO-3 Sector Specific Methodology Consultation - Overview Document \(ofgem.gov.uk\)](#), para 2.38, [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 1.8



■ [REDACTED]

1.14. While the sentiment from Ofgem that it would not be in consumer interest for investors to bear asset stranding risk (Finance Annex 1.7) and that costs should be recouped from current and future customers (Finance Annex 1.8) is positive, it is essential that we progress a mechanism with Ofgem, DESNZ, and Treasury to provide certainty around asset / cost recovery in the scenario of rapid customer disconnection of the networks alongside the ability to recover the additional costs associated with the subsequent decommissioning.

1.15. A long-term sustainable strategy across Ofgem and Government is required. This strategy needs to consider investability and provide a robust and meaningful financeability assessment over a multiple price control horizon to ensure Gas networks are given an appropriate cost of capital to ensure each can attract and maintain capital in both debt and equity markets to maintain an orderly transition to Net Zero.

■ [REDACTED]

■ [REDACTED]

■ [REDACTED]

[REDACTED]

1.17. In the table below we have provided a summary response to each of the questions. The reasoning and evidence are provided in the full answers.

SSMCQ & No.		Position	Headline message
FQ1	Do stakeholders consider there to be good reasons to deviate from the overall approach set out under UKRN Recommendation 8?	Take into account evidence	<p>In principle, we broadly agree with the overall approach set out under UKRN Recommendation 8. However, and crucially, in the SSMC, Ofgem states that where the UKRN Guidance is not sufficiently prescriptive, they are open to evidence as to the most appropriate parameter to use. In relation to cost of debt, we submit market evidence showing an increase in GDN's cost of debt since RIIO2 relative to tenor-adjusted iBoxx Utilities index and also in comparison to the cost of debt of electricity networks, driven by the perceived increase in risk. The cost of debt allowance calibration methodology needs to reflect this. In addition, there needs to be a carefully managed transition to any justified change in the inflation treatment of setting the cost of debt allowance and interaction with RAV indexation. This should include how derivatives are considered across all Finance aspects of the price control parameters, particularly, but not limited to levels of indexed linked exposure.</p>
FQ2	Do stakeholders have evidence in support of, or opposition to, one or more of the updated indexation or inflation remuneration methodologies under consideration?	Evidence provided. Inflation Option 2 least disruptive.	<p>Ofgem are proposing a new concept in the indexation process, and we do not believe this methodology has been through enough detailed discussions and worked examples to provide a definitive answer to this question at this stage (e.g., the interactions of company / sector specific factors into the calibration exercise). To expand further, we want to clarify how the evidence presented below, showing the growing gas risk premium versus electricity, will be incorporated into the cost of debt allowance methodology. There is now growing evidence that debt investors require a premium for investing in gas networks versus electricity. There is also clear evidence that GDNs are having to issue at shorter tenors (increasing refinancing risk), both in comparison to what they have historically been able to achieve and to those achieved by electricity.</p> <p>There may well be additional factors other than the new financing requirement driven by RAV growth that should influence the calibration exercise. With regard the having more cohorts for the calibration exercise, there are clearly advantages of targeting specific factors influencing debt costs in that cohort but there are fewer data points that may drive atypical distortions. This needs to be considered in the future development of the indexation methodology along with the use of cross checks to avoid any unintended consequences.</p> <p>Regarding inflation in the cost of debt allowance, based on the information presented by Ofgem to date, and in the event Ofgem considers it necessary to deviate from the existing methodology and amend the cost of debt allowance mechanisms with respect to the inflation (leverage) effect, we believe option 2 provides the least disruptive change to stakeholders. Option 1 has several detrimental impacts on regulatory stability and consumer bills. Under option 3 (review the long-term inflation forecast) it is unclear what index could be better than the current OBR and we have major concerns over any proposed use of long-term breakeven inflation. Our preference is subject to its final design not leaving actual companies with an inflation exposure or impacting their financial resilience in a manner that could not have been anticipated when they made their capital structure decisions (e.g., treatment of indexed linked debt including derivatives, see FQ3).</p>

SSMCQ & No.		Position	Headline message
FQ3	Do stakeholders have views on the potential approaches to implementation of the proposed methodology changes, including assumptions relating to ILD weights?	Concerns	<p>Inflation-linked debt has been used as a key element in implementing an efficient financial strategy in Networks for many years. In RIIO-GD1/T1, the Index Linked Debt (ILD) proportion was 25% and, for RIIO-GD2/T2, Ofgem increased the notional company's proportion of indexed linked debt for the current price control to 30% to improve the financeability of the notional company. Given this, any material change without an orderly transition would be inconsistent, as many companies have used ILD to align their exposures to that of their regulator's notional companies.</p> <p>We believe the ILD portion assumed in the proposed cost of debt mechanisms should be based on each company's actual ILD portion. However, If Ofgem were to adopt another methodology resulting in a much lower proportion (e.g., 0%) of indexed linked debt in the notional company, there needs to be careful management so that companies are not left overly exposed to inflation through existing debt and derivatives, and thus financial resilience issues, due to historical actual company decisions which could not have anticipated such abrupt changes to the cost of debt mechanism. Also, we are aware of at least two rating agencies expressing concern with setting a lower (i.e., 0%) proportion.</p> <p>Any transitional period would need to reflect the organically derived wind-down of such debt and derivatives which will be significantly greater than the 10 years Ofgem is suggesting. Notwithstanding this important point, if a notional ILD % assumption is used, this should be based on the average actual company (including index linked derivatives) – again meaning on average neither consumers nor networks should be exposed to the (leverage) effect.</p> <div style="background-color: black; height: 50px; width: 100%;"></div>
FQ4	Do stakeholders wish to propose any other alternatives that have not been proposed?	Yes	<p>As stated in FQ2, it is important that the premiums to electricity and shorter tenors we are seeing in the debt markets are reflected in the design of the indexation for RIIO3. We recognise further work is required to design such a mechanism in more detail, but we feel this would enable the differences with the electricity sector in terms of tenor, composition, and relationship to iBoxx to be reflected.</p> <p>As set out in FQ2, if Ofgem are considering to moving away from the current cost of debt methodology regarding inflation, whilst we are not proposing a new option, we do believe important refinements could be made. For example, if option 3 was decided, despite the concerns that we have set out in our response to FQ2, we believe that a 'cap and collar' would be required to limit exposure. We also believe that more alternative indices could be considered for Option 3, however, there would need to be a high bar (demonstrating it is more accurate) to move away from the current OBR index.</p>
FQ5	Do stakeholders have any additional evidence for us to consider in our review of the additional borrowing allowances or infrequent issuer premium?	Should be higher than RIIO2	<p>We have provided evidence in Nera's Additional Cost of Borrowing Report for the ENA<sup>17</sup> which estimates the allowance should be 57bps (within a range of 54-59 bps), excluding the infrequent issuer premium for the sector. When factoring in the assumption that GDNs issue shorter tenor debt of around 10 years (in line with the evidence provided in our response to FQ2), these additional borrowing costs increase to 67bps p.a. (with a range of 57-77 bps) due to the risks around the future role of gas networks. The main differences from the RIIO-2 allowance are the quantum of the liquidity/Revolving Credit Facility cost, cost of carry and CPIH premium, and inclusion of the New Issue Premium, as set out below. We also believe there should be an infrequent issuer premium, estimated at 14 bps by Nera (within a range of 10-18 bps) applied to networks that are expected to issue less than £250m pa, also evidenced below. Further additional borrowing costs may be required dependent on any further financial resilience measures introduced, including proposed amendment to the "availability of resources" condition. If Ofgem consider increasing the liquidity test period to assess financeability and sufficiency of available resources, as per FQ15, we would expect this to increase the additional borrowing costs for companies given holding considerably more committed liquidity will come at an incremental cost.</p>

<sup>17</sup> Nera 'Additional Cost of Borrowing for the RIIO-3 Price Control', March 2024, p2.

SSMCQ & No.		Position	Headline message																				
FAQ6	Do stakeholders agree with our interpretation and proposed application of UKRN Recommendations 2-7?	Concerns over implementation	<p>Our approach to setting the base RIIO-3 cost of equity for energy networks is evidenced in Oxera's Cost of Equity Report, and results in the following CAPM Cost of Equity Range at 60% gearing of 5.08% to 6.48%. This methodology is aligned with the UKRN recommendations<sup>18</sup>. The asset beta range we present of 0.32–0.37, with a mid-point of 0.349, is consistent with Ofgem's RIIO 2 range and is an appropriate RIIO-3 energy network baseline beta, before incorporating sector specific and forward-looking risks.</p> <table border="1"> <thead> <tr> <th>CPIH real</th><th>Oxera low</th><th>Oxera high</th><th>Oxera mid</th></tr> </thead> <tbody> <tr> <td><b>RFR</b></td><td>1.84%</td><td>1.84%</td><td>1.84%</td></tr> <tr> <td><b>TMR</b></td><td>6.50%</td><td>7.50%</td><td>7.00%</td></tr> <tr> <td><b>Equity beta (at 60% gearing)</b></td><td>0.70</td><td>0.82</td><td>0.76</td></tr> <tr> <td><b>Cost of equity</b></td><td>5.08%</td><td>6.48%</td><td>5.78%</td></tr> </tbody> </table> <p>As set out in our response to FAQ7, whilst Oxera's report aligns with UKRN Recommendations 2-7 and the underlying guidance, we disagree with some of Ofgem's proposed interpretation and application in relation to the RFR, TMR and Point Estimate, which are material and are set out and evidenced in our response below.</p> <p>Furthermore, we set out below why significant weight has to be put on 10 year National Grid betas for GDNs, to incorporate the historical gas activities of National Grid, and explain how uncertainty and risk regarding the future of gas has increased since RIIO-2 and the resultant systematic and asymmetric risks need to be incorporated in the asset beta and cost of equity calculation.</p> <p><i>Note – The Oxera report needs to be taken in conjunction with the Frontier Equity Investability report which shows that cross checks support a material uplift even to the top end of the cost of equity range. FAQ14 covers this 'equity financeability test' in more detail.</i></p>	CPIH real	Oxera low	Oxera high	Oxera mid	<b>RFR</b>	1.84%	1.84%	1.84%	<b>TMR</b>	6.50%	7.50%	7.00%	<b>Equity beta (at 60% gearing)</b>	0.70	0.82	0.76	<b>Cost of equity</b>	5.08%	6.48%	5.78%
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FAQ7	Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 2-7?	Concerns over implementation	<p>Overall, we do not believe there are good reasons to deviate from the respective approaches set out under UKRN Recommendations 2-7, at this early stage in the RIIO-3 process. However, as noted in our response to FAQ6, we disagree with some of the ways Ofgem are proposing to interpret and apply the UKRN Recommendations and Guidance. We believe these interpretations are material and the Oxera report recommends some alternative approaches to interpreting and applying the UKRN Recommendations and Guidance, whilst being compliant with them.</p>																				
FAQ8	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?	Do not agree	<p>The high level UKRN recommendation (3) on RFR does not cover how to convert RPI-real yield to CPIH real inputs, but the more detailed Guidance recommends that long run inflation forecasts or inflation swaps should be used to adjust RPI-real yields to CPIH-real. It is important that Ofgem takes account of what is stated in the Guidance section for each parameter as well as the high level recommendations. Furthermore, as per the RFR section of our response to FAQ6, a CPI-CPIH differential should also be applied be reflected in the calculation of the RPI-CPIH wedge.</p>																				

<sup>18</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#)

SSMCQ & No.		Position	Headline message
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?	Future risks need adding to CAPM range	We set out below why significant weight has to be put on 10 year National Grid betas for GDNs, to incorporate the historical gas activities of National Grid. This sets an initial baseline, however, for gas networks the uncertainty on the future of gas and the asset stranding risk has notably increased since RIIO-2 final determination, which debt investors have already reflected in gas vs electricity debt premiums and shorter tenor. We explain why the associated systematic and asymmetric risks need to be overlaid on top of long-term betas, in the asset beta and cost of equity calculation, to capture this forward looking risk.
FQ10	Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 1 and 9?	Enhancements required	<p>In principle we agree with Recommendation 1 that regulators should estimate the allowed return based on notional company WACC for the sector. However, a partial departure would be required for Cost of Debt inflation options 1 and 2, as detailed below.</p> <p>With regards to Recommendation 9 (regulator assessment of notional gearing) we believe the guidance should be enhanced so the most relevant factors are taken into account, namely, an assessment of actual companies' levels of gearing, impact assessments of any proposed change from RIIO2 and assessing the drivers behind any proposed change and whether these should be addressed at source.</p>
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?	No	<p>As detailed in our response to FQ10, we believe the most relevant factors when assessing notional gearing are assessment of actual companies' levels of gearing, impact assessments of any proposed change from RIIO2 and assessing the drivers behind any proposed change and whether these should be addressed at source. We currently believe there is no evidence to deviate from the RIIO2 assumptions.</p> <p>We currently believe there is no evidence to deviate from the RIIO2 gearing assumptions.</p>
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	Agree in principle	We agree with statement in para 4.11 of the Finance Annex that 'it may be more intuitive to assume that the notional capital structure remains constant in each year of the price control and that variables such as net issuance of debt and equity are varied in order to achieve this'. However, we think this should be further considered and consulted on once an initial Business Plan Financial Model has been populated and again when the price control calibration is known.



SSMCQ & No.	Position	Headline message
FQ13	What, if any, improvements should Ofgem make to the assessment of financeability in the next price control?	<p>Changes required</p> <p>It is important for the financeability assessment to be designed in such a way that it can provide meaningful information about a sector's ability to raise debt financing on efficient terms and its links to equity investability. Given the significant uncertainty surrounding the future of gas networks and significant macro-economic uncertainty - a number of important changes to the financeability assessment need to be considered including; (i) extending the assessment horizon beyond RIIO-3, (ii) undertaking a more rigorous risk assessment by developing robust downside scenarios, (iii) considering how credit agency views may evolve and (iv) linkage to equity investability. Finally, any changes in notional company assumptions from the previous price control need to be fully justified and subject to an impact assessment.</p> <p>Ofgem has a legal statutory duty to have regard to the need to secure that companies are able to finance their activities. The assessment therefore must be investigated robustly recognising the statutory importance of the issue and the potential changes for GDNs over the next 20-30 years.</p>
FQ14	What evidence, if any, should Ofgem consider in relation to expanding its assessment of financeability to account for 'investability'?	<p>Support Equity Invest-ability test</p> <p>We welcome Ofgem's intention to develop the notion of investability in the SSMC (welcoming the increased emphasis on investability, while noting that Ofgem should always be seeking outcomes where networks can obtain necessary investment). Equity financeability (investability) must focus on assessing whether the equity return proposed by Ofgem is competitive versus the other opportunities that exist in the wider capital market. We believe investability improves the financeability assessment, providing the potential to serve the equity investor in the same way that financeability serves the debt investor (i.e., by testing whether a notional licensee can service reasonable debt costs and maintain financial metrics).</p> <p>Investability is critical to RIIO3 because.</p> <ul style="list-style-type: none"> <li>• there have been material changes to the capital market conditions since RIIO2 was set.</li> <li>• all Networks will face huge challenges and heightened risk in RIIO-3 due to the transition to net zero.</li> </ul> <p>Although Ofgem appears to have been motivated in its discussion on investability by the pace of growth anticipated for electricity networks, investability is as much a challenge for gas networks. This is due to the need to retain existing equity as well as attract new equity investment to maintain safety and security of supply in the context of significant downside and uncertainty over the future of gas, the impact of which we are already seeing in debt market spreads and tenor decisions as highlighted in our response to FQ2.</p> <p>Notwithstanding these key points - not considering the investability of a sector with significant uncertainty and risks over its future will directly impact the appetite and cost of investment in other UK energy regulated sectors as investors will tend to assess investability across the whole life cycle of their investment.</p> <p>Safeguarding equity investability requires that the cost of equity lies sufficiently far above the long-term return on senior investment-grade debt. A Frontier report and Oxera report submitted with this response clearly demonstrate with evidence that rolling forward RIIO2 cost of equity only updating for the latest information on gilt yields, would mean RIIO-3 is not investable. Therefore, changes are required to the RIIO-2 Cost of Equity Methodology as set out in our response to FQ6. Investability also needs to be appropriately defined.</p>

SSMCQ & No.	Position	Headline message
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?	Maintain current measures	<p>SGN take financial resilience very seriously and note there are already extensive licence requirements that network energy companies must comply with. We are not aware of any financial resilience concerns amongst network energy companies despite the financial crash of 2008 and turmoil over recent years. Whilst we understand the need for the regulator to maintain vigilance and look at best practice, it is also important that any changes proposed provide value for money and the benefits to consumers outweigh the costs of implementing the change. We do not believe this has been assessed and currently we think the costs of the proposed changes will outweigh any benefits and are therefore disproportionate.</p> <p>[REDACTED]</p> <p>In terms of other measures, we would propose, we believe consistency in targeting a certain financial resilience threshold would be improved if a correct / comparable type of rating is used across companies. Specifically, we believe that the senior debt rating (rather than the IDR) would be a more appropriate rating to monitor, to factor in recovery considerations and to allow better comparison with the ratings of other agencies (where rating definitions may vary).</p>
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?	Maintain current measures	<p>As detailed in our response to FQ15 we believe existing powers are sufficient. It has not been clearly established (i) that the consumer benefits outweigh the costs of implementing such changes, (ii) what market failure that any new changes are targeting to address (iii) that the proposed changes are consistent with Ofgem's duties. Therefore, we believe any introduction of new regulation should, following good regulatory practice, be targeted at the specific market or regulatory failure. Existing failures relating to excessive leverage should first be identified and then an impact assessment made considering the proposed remedy before introducing new regulations.</p>
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?	Maintain current measures	<p>[REDACTED]</p>

SSMCQ & No.		Position	Headline message
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?	Unclear there is a need	As detailed in our response to FQ15 we are unclear what problems the stress testing is trying to test. The risks faced by network energy companies are different to the retail sector and banks and therefore this is unlikely to be valid comparison. However, we do take financial resilience very seriously and if an impact assessment shows that some form of stress testing is in consumer interests compared to the cost and burden imposed by the amended RIGs, then we remain open minded. It should be noted that stress tests on financeability drivers are already routinely carried out as part of the price control review (revisions to which are detailed in our response to FQ13).
FQ19	Do you agree with our proposal to align the RIIO-3 tax approach with RIIO-2 and RIIO-ED2 including; to maintain Option A – notional allowance with added protections; the approach to capital allowances, and “glide path”?	Broadly agree	Overall, we agree with the proposal to align the RIIO-3 tax approach with RIIO-2. However, it needs to be made clear the tax review process is symmetrical, i.e., that it applies if tax allowance is incorrectly below actual tax as well as above. This is also a Financial Resilience consideration in terms of having financeability protection against allowed tax being incorrectly materially below actual tax.
FQ20	Do you agree with the proposed revision to tax clawback methodology?	Review needed	Ofgem propose a change in RIIO-3 to include cumulative accretion (net of paydown) in the regulatory definition of net debt, to calculate gearing for the tax clawback calculation. This is clearly a complex area, and we suggest that the tax clawback methodology for RIIO-3 is reviewed by the Ofgem-ENA Tax Working Group.
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?	More optimal tools	<p>We welcome the position Ofgem has taken that it is not in consumer interests for asset stranding risks to sit with investors (as per para 1.7 and 8.15 of the Finance Annex). However, we also note that the mechanisms that could be deployed to ensure this is the case, with the exception of accelerated depreciation, would require government decisions and are therefore ultra vires for Ofgem at this stage.</p> <div data-bbox="683 1451 1497 1590" style="background-color: black; height: 60px; width: 100%;"></div> <p>In fulfilling its regulatory duties, it is incumbent on Ofgem to push and advocate for collective solutions, but also in the absence of such certainty, to recognise the risk that exists now and to ensure that this is accounted for in RIIO-3. Indeed, the ongoing risk will need to be factored in as a risk premium that is already demonstrable in recent debt transactions and for equity the concept of investability concerns driven by uncertainty and risk will need to be quantified and remunerated appropriately in the Cost of Equity.</p>

SSMCQ & No.		Position	Headline message
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?	More optimal tools	As stated in our response to FQ21, we believe accelerated depreciation is not the optimum way to implement a flexible cost recovery mechanism from consumers. As discussed earlier in this response to the Finance Annex questions, due to concerns over FES and the lack of a developed plan to deliver policy intent for Net Zero, it would not be possible anyway to profile accelerated depreciation appropriately.
FQ23	GD & GT: assuming there is a relevant gas reopener for government policy, is there a need to reopen regulatory depreciation policy intra-period?	Not Required	As stated in our response to FQ21, we believe accelerated depreciation is not the optimum way to implement a flexible cost recovery mechanism from consumers. We believe dialogue should start immediately with Ofgem, Government and Stakeholders to develop the management of this risk more holistically with a commitment to protecting investors (which we believe is also in consumers best interests). Therefore, there is no requirement for a re-opener.
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?	Too early	Until there is a degree of certainty regarding asset repurposing, which is likely to be far into the future and subject to so many variables, the likely value cannot be predicted with any reliability. Therefore, SGN believe it would not be prudent to add another risk variable, on top of network usage, into the assessment of asset stranding and cost recovery risk. As stated in FQ21, a commitment to a government backstop would eliminate the need to assess these uncertain variables now.
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.	N/A	We do not have any visibility of ET Business Plans so cannot comment.

SSMCQ & No.		Position	Headline message
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?	No impact	<p>[REDACTED]</p> <p>Any decision on 'semi nominal' cost of debt and WACC would not change our position on accelerated depreciation or justification for a commitment to provide a backstop to asset stranding and cost recovery risk.</p>
FQ27	Do stakeholders have views or evidence as to why RAMs should or should not continue?	Support	SGN would support RAMs being continued in RIIO-3 as in principle they protect consumers and companies for extreme circumstances.
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?	Too early	It is too early in the price control process to comment on whether the RAMs methodology should be adjusted for factors such as recalibrating the thresholds, rates or including financial performance. The precise design and calibration need to be consulted on once the whole price control package is known, for example the treatment of inflation in setting the allowed cost of debt or the uncertainty mechanism package.
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?	Separate	For GDNs our initial thinking is that we believe if there is material reopener/government policy change, such as on heat policy, then the impact of this reopener could be included in a separate RAM. This is because it may have a different risk profile to the core totex.
FQ30	Is there a case for altering the capitalisation rate modelling approach between sectors (e.g., removing the multiple bucket approach for GD)?	View	<p>[REDACTED]</p> <p>[REDACTED]</p>
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?	Outturn rate supported	SGN believe an outturn capitalisation rate should be adopted, as this should reduce the risk of detrimental cashflow and credit metric impacts currently caused by not updating ex ante capitalisation rates for actual totex. We indicatively support option D in para 10.9, i.e., reporting an outturn capitalisation rate for overall actual totex. However, it needs to be considered whether option D still leaves an avoidable cashflow and credit metrics risk, and further detail is required on the options before any firm decisions are made,

SSMCQ & No.		Position	Headline message
FQ32	Are there any reasons why the RIIO-3 approach to directly remunerated services should differ from RIIO-2?	Review	We believe that due to the fast-changing environment regarding delivering net zero, it is timely for Ofgem to look at whether the current rules around directly remunerated services best support net zero delivery across the sector. This could include categories of work (See FQ33) or rules around de minimis work.
FQ33	Do stakeholders have any reasons or evidence to suggest more directly remunerated service categories are necessary?	Yes	Given the downside risk and uncertainty facing GDN's, there may be value in conducting more consented or de minimis activity if utilisation of the network falls, but assets are still required. We believe it is in all stakeholder's interest to incentivise some incremental utilisation of assets and workforce.
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?	Retain current approach	We believe the intergenerational consumer case for change is not strong enough to justify the potential revenue volatility and credit metric impact that treating all disposals as fast money would have. Therefore, unless there is a stronger consumer driver that outweighs the material financeability concerns, we support retaining the existing policy.
FQ35	Do stakeholders have views or evidence as to what reporting information should be provided to Ofgem (under the RPFs or other forms) to ensure objective identifiability of repurposed assets and cost data remains appropriately like-for-like?	Proportionate	The collection of information via the RFPR or other mechanisms must be proportionate to the demonstrable benefit it has to future decision making. If changes to reporting meets this test, then we would be supportive. We believe the task of identifying relevant information and the cost / benefit of this should be delegated to the cost assessment working groups.
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?	Yes	We believe that Ofgem already has a comprehensive suite of obligations and mechanisms in place and encourage Ofgem to clarify the concerns that they are looking to address. We note that revised policy has only been in place for one year and that it may be more appropriate to ensure that the updated guidance is applied appropriately and consistently before introducing further changes.

SSMCQ & No.		Position	Headline message
FQ37	Do you have any other suggestions for clarifying or strengthening the reporting requirements with regard to executive pay/remuneration, dividends or corporate governance?	No	We believe the RIGs consultation later this year is the appropriate forum.
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?	Nothing material	SGN do not feel that the PCFM requires major changes. One area of improvement would be with greater visibility of adjustments to prior year revenues for stakeholders and also movements from the previously published PCFM.
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?	Supportive	SGN would be supportive of licenses self-publishing the PCFM, which is similar to the process undertaken for GD1. However, were this to be the case we would like to tailor the AIP dry run process to only submitting a PCFM at the beginning and end of the process.
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?	As per RIIO-2	Our position has not changed from that adopted by Ofgem of RIIO-GD2/T2, i.e., that WACC should be applied to revisions to PCFM inputs whilst a Cost of Debt figure should be applied to k correction (under/over recovery errors). We understand the application of a single time value of money adjustment is being driven by a proposal to combine the ADJ and k terms into one. We understand these terms are combined in the RIIO-ED2 PCFM, but we are not sure of the advantages of this. This is because not separately seeing changes in the total amount of allowed revenue networks are allowed to collect, and timing of collecting that revenue, seem fundamental to the transparency of the process (as set out in our response to FQ38).

## Appendix 3- RIIO-3 Sector Specific Methodology Consultation – Finance Annex

### 2. Section 2. Allowed return on debt

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

- 2.1. In principle, we broadly agree with the overall approach set out under UKRN Recommendation 8. However, and crucially, in the SSMC, Ofgem states that where the UKRN Guidance is not sufficiently prescriptive, they are open to evidence as to the most appropriate parameter to use. In relation to cost of debt, we submit market evidence showing an increase in GDN's cost of debt since RIIO2 relative to tenor-adjusted iBoxx Utilities index and also in comparison to the cost of debt of electricity networks, driven by the perceived increase in risk. The cost of debt allowance calibration methodology needs to reflect this. In addition, there needs to be a carefully managed transition to any justified change in the inflation treatment of setting the cost of debt allowance and interaction with RAV indexation. This should include how derivatives are considered across all Finance aspects of the price control parameters, particularly, but not limited to levels of indexed linked exposure.
- 2.2. In principle we agree with the overall approach set out under Recommendation 8 of the UKRN report which states;
- 2.3. *'Regulators should estimate an allowance for an efficient company under the notional financial structure with actual debt costs suitably benchmarked against other market evidence.'*<sup>19</sup>
- 2.4. However, and crucially, it is important that Ofgem remains open to evidence and, as the economic regulator for gas and electricity networks, sets a regulatory structure that is appropriate to the investment requirements of those sectors. It is also important to consider an efficient gas distribution company with the risks that the sector is exposed to rather than a generic energy network as there are substantial differences. Furthermore, it is important that Ofgem remains "open to evidence as to the most appropriate parameter to use"<sup>20</sup>. As set out in our response to FQ2 and FQ3, Ofgem needs to recognise:
- the market evidence we present in this response showing a material increase in the cost of debt for GDNs relative to tenor-adjusted iBoxx Utilities index since the start of RIIO2;
  - the market evidence of the significant reduction in tenors of new debt in the gas sector, causing a shift in the types of financing in the gas sector, particularly, in favour of private markets, driven by the limited tenors available in public markets. Shorter tenors will also increase refinancing risk;
  - a carefully managed transition to any justified change in the inflation treatment of the cost of debt mechanism; and
  - a review of the inclusion or exclusion of derivatives across all Finance aspects of the price control parameters, as highlighted in FQ2.
- 2.5. Inclusion of market evidence and policy justification is vital in order for there to be predictability and stability in the regulatory regime, as supported by the UKRN WACC guidance. For example, Ofgem need to ensure that the cost of capital and, hence, customer's bills, are no higher than they need to be.

<sup>19</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#), p33

<sup>20</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 3.7.



- 2.6. It is also worth highlighting that the guidance states, “Regulators have a role in supporting this by adopting a consistent approach to remunerating debt costs over time”<sup>21</sup> and “Recognising the value of predictability and stability when attracting finance that may span several control periods, regulators agree that early signalling and an evidence-based rationale will be necessary to manage the effects of a change of approach in this area.”<sup>22</sup> As we further discuss in our responses below, it appears to us that Ofgem’s proposed options do not seem to be fully evidenced at this stage.

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

- 2.7. Ofgem are proposing a new concept in the indexation process, and we do not believe this methodology has been through enough detailed discussions and worked examples to provide a definitive answer to this question at this stage (e.g., the interactions of company / sector specific factors into the calibration exercise). To expand further, we want to clarify how the evidence presented below, showing the growing gas risk premium versus electricity, will be incorporated into the cost of debt allowance methodology. There is now clear evidence that debt investors require a premium for investing in gas networks versus electricity. There is also clear evidence that GDNs are having to issue at shorter tenors (increasing refinancing risk), both in comparison to what they have historically been able to achieve and to those achieved by electricity.
- 2.8. There may well be additional factors other than the new financing requirement driven by RAV growth that should influence the calibration exercise. With regard the having more cohorts for the calibration exercise, there are clearly advantages of targeting specific factors influencing debt costs in that cohort but there are fewer data points that may drive atypical distortions. This needs to be considered in the future development of the indexation methodology along with the use of cross checks to avoid any unintended consequences.
- 2.9. Regarding inflation in the cost of debt allowance, based on the information presented by Ofgem to date, and in the event Ofgem considers it necessary to deviate from the existing methodology and amend the cost of debt allowance mechanisms with respect to the inflation (leverage) effect, we believe option 2 provides the least disruptive change to stakeholders. Option 1 has several detrimental impacts on regulatory stability and consumer bill. Under option 3 (review the long-term inflation forecast) it is unclear what index could be better than the current OBR and we have major concerns over any proposed use of long-term breakeven inflation. Our preference is subject to its final design not leaving actual companies with an inflation exposure or impacting their financial resilience in a manner that could not have been anticipated when they made their capital structure decisions (e.g., treatment of indexed linked debt including derivatives, see FQ3).

### Market Evidence showing materially increased costs in GDN’s cost of debt

<sup>21</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#), pg. 32

<sup>22</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#), pg. 35

- 2.10. UKRN guidance states Regulators using an index to benchmark notional company costs should consider how aligned the index characteristics are with evidence from actual sector issuance (which provides insight into the cost base of an efficiently run notional company). An adjustment to the index may be appropriate where there is strong and consistent evidence that suggests the unadjusted index is likely to provide a poor proxy for the notional company's cost of debt. In making such an adjustment, regulators should clearly set out the evidence base informing their decision, and the size of adjustment made. We believe based on the market evidence presented below, an unadjusted iBoxx Utilities index would be a poor proxy for the notional GDN's cost of debt.
- 2.11. There is now clear evidence that debt investors require a premium for investing in gas networks versus electricity. There is also clear evidence that GDNs are having to issue at shorter tenors, both in comparison what they have historically been able to achieve and in comparison to those achieved by electricity. Both these trends are evidenced in the confidential KPMG Debt Market Analysis report for the GDNs<sup>23</sup>. The report highlights two key points;
- GDNs' cost of debt has been increasing relative to both the UK benchmark (Government bonds) and a tenor adjusted iBoxx index since 2013 (see report sections 1.3.1 and 1.3.2 for further details). The GDN-electricity spread has been higher since the start of 2022 and will continue to be so if gas is perceived to be of higher risk (see report section 1.4.1), with secondary market gas spreads continuously trading higher than electricity spreads. The difference in spreads against Government bonds has averaged 29 bps for A-rated bonds and 15 bps for BBB-rated bonds, and from early 2023 the spread has widened further. The same trend is observed when comparing spreads against the tenor adjusted index, with spread differentials 24 bps for A-rated bonds and 19 bps for BBB-rated bonds.
  - Tenors for new debt issuance are shortening and are now lower than the electricity and water sectors, and this has an impact on how GDNs manage their debt and the long-run cost of raising their debt. Tenor at issue for GDNs fell from an average of 15.4 years in 2014-2018 to 10.1 years in 2020-24. Tenor at issuance is now 5 years lower than electricity transmission networks and 7 years less than electricity distribution networks (see report section 1.3.3 for further details). Since 2020 no benchmark-sized debt in the GD sector was issued with tenor greater than 12 years in public markets.
- 2.12. These restrictions on tenor length, imposed by the market, mean GDNs are increasingly limited in the tenors they can issue at, leading to challenges in managing debt portfolio maturity concentration risks and in achieving average tenors at issuance that more closely match the trombone average iBoxx tenor. This reduces their ability to strike a balance between minimising interest costs, managing risk and raising debt to better-match the trombone average iBoxx tenor, and should be taken into account in the calibration of the cost of debt allowances and financeability assessments. As highlighted in NERA's GDN's Borrowing Costs report<sup>24</sup> covering the impacting of reducing tenors on additional borrowing costs, issuing shorter debt over time means more upfront costs in raising said debt, and a shorter period over which upfront fees are capitalised. This has led NERA to suggest increasing the 'Transaction Costs' element of additional borrowing costs allowance by 2.5 bps and the 'Cost of Carry' element by up to 15 bps vs all energy networks, assuming an average tenor at issuance of 10 years.
- 2.13. There is also a growing issue of capital availability in the sector. SGN observes that there is a shrinking pool of debt investors in the UK public bond market, and that GDNs are finding that fewer investors offering debt due to ESG considerations and a perception of exposure to asset stranding risk in the long term (concentrating risk), and the debt that is being offered is at shorter tenors. This is a significant and increasing issue in the GDN sector which Ofgem needs to address.

<sup>23</sup> KPMG 'Debt Market Analysis: gas distribution networks and UK regulated comparators' March 2024

<sup>24</sup> Nera 'Impact of GDN's Reduced Debt Tenor on Additional Cost of Borrowing at RIIO-3', March 2024

- 2.14. UKRN guidance states that “Regulated companies use other forms of financing, not just bonds, depending on their financing strategy and risk appetite. Depending on their materiality within their sector, some weight has been given to these instruments in previous regulatory determinations.”<sup>25</sup>
- 2.15. In line with the UKRN guidance, it is important to reflect the private debt markets. The private debt market has been of increasingly important source of finance over the last 3 to 4 years as the tenor at issue for public debt in the gas distribution sector has reduced significantly. The reduction in tenor in the public markets is due to the changes in debt investor sentiment and concerns over the long-term demand uncertainty as expressed under Government and Ofgem messaging. To mitigate the impact of this on maturity concentration and refinancing risk management, it has been necessary to enter the private debt market, however, private debt is generally more expensive than public debt due to investors usually requiring an illiquidity premium to invest in an instrument which is less/not traded on exchange. It is therefore important that a forward-looking mix of public and private financing should be incorporated in the gas distribution sector’s calibration of cost of debt allowances.

#### Treatment of Inflation in setting the cost of debt allowance

- 2.17. RAV indexation and real WACCs have been a cornerstone of the regulatory framework for decades and have enabled many billions of pounds of new investment to be efficiently funded. Any move away from these, therefore, should be approached with great caution and after careful consideration.
- 2.18. All the proposed options substantially change the way the regulatory framework operates and risk allocation, and each option to varying degrees increases complexity to a level that even the Credit Rating Agencies (CRAs) who deal with technically complex RAV-regulated networks daily may need more time and clarity to understand the options proposed by Ofgem, and their impact on credit rating profiles. A robust impact assessment is required ahead of any preferred option being identified and will also require examination of the factors (See ‘Assessing the Inflation Options section’ below).
- 2.19. With regards to the inflation remuneration methodologies, if Ofgem feels it is necessary to move away from the existing methodology, we assess that the (leverage) effect will be removed under option 1 ‘nominal allowance for fixed rate debt’ and option 2 ‘match indexation of the RAV to the long run assumption in proportion to the fixed rate debt notional capital structure proportion’ such that neither consumers or networks are exposed to a misalignment between actual and forecast inflation on their cost of debt. Our assessment of the options assumes in value terms options 1 and 2 are identical.
- 2.20. We are not supportive of option 3 ‘unchanged methodology – review of long run assumption’. Ofgem has stated that in the event it does not opt for Options 1 and 2 to address the leverage effect, it would “review the long run assumption to consider whether there is a more appropriate measure of long-term inflation expectations priced into debt”.<sup>26</sup>

<sup>25</sup> CoC-guidance 22.03.23.pdf (ukrn.org.uk), p32

<sup>26</sup> RIIIO-3 Sector Specific Methodology Consultation – Finance Annex (ofgem.gov.uk), paragraph 2.39.

- 2.21. We assess that the proposed Option 3 will not remove the leverage effect given it is highly unlikely that any forecast would predict the actual inflation for a price control 100% accurately, particularly short-term variation. Instead, it changes the characterisation of the risk by introducing alternative forecasts for long-term inflation expectations and how they are priced into debt. As detailed in Frontier's report on break-even inflation<sup>27</sup> there are a number of concerns that would need to be resolved before option 3 could be considered. These include;
- The need to define the meaning of an “appropriate” measure of long-term inflation.
  - The need to set out why the OBR is no longer fit for purpose given its alignment with Government objectives and the achievement of these over the long run when excluding the recent period of unusually high and unpredictable inflation, and the subjectivity involved in choosing an alternative forecast.
  - The need to demonstrate that any alternative forecast is balanced and that the risk is symmetrical between customer and investors.
  - Ofgem has not considered other alternative inflation forecasts to break-even inflation. Alternatives could include a composite of short (OBR or HMT) and long run forecasts (Bank of England's target of 2%)<sup>28</sup>.
  - Ofgem has not shown evidence to suggest break-even inflation is a superior measure of long-run inflation when compared to alternatives including OBR forecasts. Break-even inflation has a number of flaws, as set out in Frontier's report<sup>29</sup>, including;
    - there are a number of factors that impact its level apart from RPI inflation expectations.
    - it was not better than the OBR in predicting the recent and sudden unusually high inflation.
    - Issues with pricing in 2030 RPI reform (RPI being brought in line with CPIH).
- 2.22. Furthermore, a significant change in the level of forecast long-term inflation would signal a very significant regulatory change and undermine the predictability and stability of the regime for equity investors and credit rating agencies, with adverse impacts on customers.
- 2.23. Considering option 1 and option 2 further (given our assumption that in value terms that these are identical) we are concerned that option 1 envisages the introduction of a semi-nominal WACC which risks increasing regulatory complexity and reducing regulatory stability. Through its introduction, the acceleration of cashflow would result in a significant impact on short to medium term bills, which we do not consider appropriate at the current time.
- 2.24. We are not aware of a semi-nominal WACC ever being adopted by any other regulator. Given the lack of stakeholder familiarity with such a structure, option 1 would require careful explanation. Furthermore, we understand some credit rating agencies hold reservations regarding the introduction of a semi-nominal WACC and there is a risk that this could negatively impact their assessment of the regulator and the predictability and stability of the regulatory regime (potentially leading to a raising of their interest cover thresholds). As a result, if option 1 was to be progressed the ramifications would need to be carefully thought through before this could be implemented.
- 2.25. Finally, our assessment is based on the assumption that the indexed linked proportion in the mechanism is consistent with our recommendation in FQ3 that the level of indexed linked debt of actual companies should be assumed in any of the three options proposed.

<sup>27</sup> Frontier 'Initial consideration of break-even inflation for price control purposes', March 2024

<sup>28</sup> Frontier 'Initial consideration of break-even inflation for price control purposes', March 2024, p5

<sup>29</sup> Frontier 'Initial consideration of break-even inflation for price control purposes', March 2024, p6-p8

- 2.26. Therefore, in the event Ofgem considers it necessary to deviate from the existing methodology and amend the cost of debt allowance mechanisms with respect to the inflation (leverage) effect, we believe option 2 provides the least disruptive change to stakeholders.

#### Proportion of Indexed Linked Debt at the Notional Company

- 2.27. In RIIO-1 and RIIO-2, the notional companies that were assessed to demonstrate financeability relied on the use of Index Linked Debt (ILD) to demonstrate their financeability. As a result, Energy network companies across all sectors entered into significant quantities of ILD in response to the notional company assumptions of 25% ILD for RIIO-1<sup>30</sup> and 30% for RIIO-2<sup>31</sup>.
- 2.28. In the SSMC, Ofgem states they are considering the lowering of the notional company to 0% ILD (para 2.43). Maintaining the predictability and stability in the regulatory regime (in line with UKRN guidance<sup>32</sup>) is very important and should a radical change to 0% ILD be implemented (which we do not support) then there would need to be careful management.
- 2.29. In our view, Ofgem recognises in the SSMC that setting the notional assumption for the share of ILD to 0% *“could adversely impact financial resilience in a manner which could not have been reasonably anticipated when licensees made these capital structure decisions”*<sup>33</sup>. It is not in consumers’ interests for companies to be left exposed to net inflation sensitivities, and thus financial resilience issues, due to decisions actual companies made historically in line with the notional company at the time they were made.

#### Treatment of Derivatives

- 2.30. This highlights an important issue, that there needs to be a review of how derivatives are treated across the Finance aspects of RIIO-3. This review is necessary as, in order to increase the proportion of ILD in their debt portfolio for the reasons outlined above, companies had to overlay synthetic index linked debt derivatives on nominal rate debt during RIIO-1 and RIIO-2.
- 2.31. The need to use synthetic index linked debt derivatives was due to the collapse of the RPI linked market during the Global Financial Crisis and then the lack of CPI linked debt. The assumed ILD % for options 1 and 2, including implementation mechanisms, need to include these derivatives to avoid unwarranted inflation exposure in RIIO-3. SGN believe there needs to be a review of why companies have increasingly entered into derivatives and how Ofgem should treat them across the other aspects of RIIO-3.

#### Assessing the Inflation Options

- 2.32. In the RIIO3 Finance annex, Ofgem set out their criteria to assess the options<sup>34</sup>. This evaluation should be undertaken as a long-term assessment and consider a variety of possible scenarios. In addition, we think that it is important to add the following criteria to the assessment;
- is the leverage effect removed at the notional / actual company?
  - are actual companies left with an inflation exposure?
  - is there cashflow volatility risk?
  - what is the impact on the basis of the cost of capital?

<sup>30</sup> [riio\\_gd1\\_fp -financialmodel\\_dec12\\_0.xlsm \(live.com\)](#) inputs tab, line 73

<sup>31</sup> [RIIO-2 Final Determinations – Finance Annex \(REVISED\) \(ofgem.gov.uk\)](#), para 2.25

<sup>32</sup> [CoC-guidance\\_22.03.23.pdf \(ukrn.org.uk\)](#), p33

<sup>33</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 2.45.

<sup>34</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 2.27.

- is there theoretical rationale underpinning to the change?
- what is the impact on investment appraisal?

2.33. If this review does justify it is in stakeholders interests to change the existing methodology, it is our view that of the options presented, option 2 provides the most robust coverage of the principles and is least disruptive to stakeholders. This should be implemented without setting the notional proportion of index linked debt to 0%.

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

2.34. Inflation-linked debt has been used as a key element in implementing an efficient financial strategy in Networks for many years. In RIIO-GD1/T1, the Index Linked Debt (ILD) proportion was 25% and, for RIIO-GD2/T2, Ofgem increased the notional company's proportion of indexed linked debt for the current price control to 30% to improve the financeability of the notional company. Given this, any material change without an orderly transition would be inconsistent, as many companies have used ILD to align their exposures to that of their regulator's notional companies.

2.35. We believe the ILD portion assumed in the proposed cost of debt mechanisms should be based on each company's actual ILD portion. However, If Ofgem were to adopt another methodology resulting in a much lower proportion (e.g., 0%) of indexed linked debt in the notional company, there needs to be careful management so that companies are not left overly exposed to inflation through existing debt and derivatives, and thus financial resilience issues, due to historical actual company decisions which could not have anticipated such abrupt changes to the cost of debt mechanism. Also, we are aware of at least two rating agencies expressing concern with setting a lower (i.e., 0%) proportion.

2.36. Any transitional period would need to reflect the organically derived wind-down of such debt and derivatives which will be significantly greater than the 10 years Ofgem is suggesting. Notwithstanding this important point, if a notional ILD % assumption is used, this should be based on the average actual company (including index linked derivatives) – again meaning on average neither consumers nor networks should be exposed to the (leverage) effect.

2.37. We also believe that any move to a lower ILD proportion needs to consider the impact this would have on the supply of inflation-linked assets for UK defined-benefit pension schemes, which rely on companies and banks (who themselves need to source the inflation risk from companies) to provide them with a regular supply of these assets to help hedge their long-term inflation-linked pension liabilities.

2.38. Energy networks across all sectors entered into significant Index Linked Debt (ILD) actual company debt positions in response to the notional company assumptions of 25% and 30% ILD for RIIO-GD1/T1 and RIIO-GD2/T2, respectively. The notional companies defined by Ofgem relied on this ILD to be financeable and thus actual companies' financial policies followed the notional company in order to maintain their own financeability.

2.39. There needs to be careful management under the proposed options, and any implementation mechanisms, in order for there to be predictability and stability in the regulatory regime as supported by



UKRN guidance<sup>35</sup>. Companies must not be left exposed to inflation, and thus financial resilience issues, due to historical actual company decisions which could not have anticipated such changes to the cost of debt mechanism. This is a principle Ofgem supports in the SSMC<sup>36</sup>. Otherwise, the proposed options and their implementation mechanisms would lead to companies having inflation exposure due to following Ofgem's notional company's assumptions. They also may have been entering into ILD to avoid inflation exposure and now actually be faced with inflation exposure due to that rational previous decision.

- 2.40. It would take many years to unwind capital structures to avoid substantial costs of restructuring current debt, and thus we believe the ILD portion should be based on each company actual ILD portion (including index linked derivatives as highlighted in our response to FQ2).
- 2.41. Notwithstanding this important point, if a notional ILD % assumption is used, this should be based on the average actual company (including index linked derivatives) – again meaning on average neither consumers nor networks should be exposed to the effect. Seeking to drive every actual company's index linked debt proportion down to 0% would be a very significant change to regulatory principles, create significant extra costs if not managed over several decades and we understand credit rating agencies have also expressed concern over the regulatory stability of this 'retrospective action'.
- 2.42. SGN also believe that any move to a lower notional ILD proportion needs to consider the impact if companies mirrored this notional assumption. For example, ILD provides companies with a diversified debt portfolio to aid risk management and protection to credit metrics during a period of negative inflation. Also, a policy change lowering ILD could have an unintended impact on the supply of inflation-linked assets for UK defined-benefit pension schemes, which rely on companies and banks to provide them with a regular supply of these assets to help hedge their long-term inflation-linked liabilities. Any transitional period would need to reflect the organically derived wind down of such debt which will be significantly greater than the 10 years Ofgem are suggesting.

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

- 2.43. **As stated in FQ2, it is important that the premiums to electricity and shorter tenors we are seeing in the debt markets are reflected in the design of the indexation for RIIO3. We recognise further work is required to design such a mechanism in more detail, but we feel this would enable the differences with the electricity sector in terms of tenor, composition, and relationship to iBoxx to be reflected.**
- 2.44. **As set out in FQ2, if Ofgem are considering to moving away from the current cost of debt methodology regarding inflation, whilst we are not proposing a new option, we do believe important refinements could be made. For example, if option 3 was decided, despite the concerns that we have set out in our response to FQ2, we believe that a 'cap and collar' would be required to limit exposure. We also believe that more alternative indices could be considered for Option 3, however, there would need to be a high bar (demonstrating it is more accurate) to move away from the current OBR index.**

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

<sup>35</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#), p33

<sup>36</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 2.45.

- 2.45. We have provided evidence in Nera’s Additional Cost of Borrowing Report for the ENA<sup>37</sup> which estimates the allowance should be 57bps (within a range of 54-59 bps), excluding the infrequent issuer premium for the sector. When factoring in the assumption that GDNs issue shorter tenor debt of around 10 years (in line with the evidence provided in our response to FQ2), these additional borrowing costs increase to 67bps p.a. (with a range of 57-77 bps) due to the risks around the future role of gas networks. The main differences from the RIIO-2 allowance are the quantum of the liquidity/Revolving Credit Facility cost, cost of carry and CPIH premium, and inclusion of the New Issue Premium, as set out below. We also believe there should be an infrequent issuer premium, estimated at 14 bps by Nera (within a range of 10-18 bps) applied to networks that are expected to issue less than £250m pa, also evidenced below, [REDACTED]. Further additional borrowing costs may be required dependent on any further financial resilience measures introduced, including proposed amendment to the “availability of resources” condition. If Ofgem consider increasing the liquidity test period to assess financeability and sufficiency of available resources, as per FQ15 we would expect this to increase the additional borrowing costs for companies given holding considerably more committed liquidity will come at an incremental cost.
- 2.46. The rationale for the individual elements of the additional borrowing costs allowance, are summarised in Table 1 as per the Nera additional cost of borrowing reports<sup>38</sup>. Table 1 also references the pages in the Nera ‘Additional Cost of Borrowing for the RIIO-3 Price Control’ report for all networks where the more detailed evidence can be found for ease of reference. Rationale for a GDN uplift needed for certain elements is put in italics<sup>39</sup>, with further detail in the short Nera report ‘Impact of GDN’s Reduced Debt Tenor on Additional Cost of Borrowing at RIIO-3’;

<sup>37</sup> Nera ‘Additional Cost of Borrowing for the RIIO-3 Price Control’, March 2024, p2.

<sup>38</sup> Nera ‘Additional Cost of Borrowing for the RIIO-3 Price Control’, February 2024, p2 and Nera ‘Impact of GSN’s Reduced Debt Tenor on Additional Cost of Borrowing at RIIO-3’, February 2024, p2.

<sup>39</sup> GDN uplift excludes any increase in NIP required to reflect heightened risk from decarbonisation of heat.



2.47. **Table 1: Additional cost of borrowing allowances**

Individual Element	Ofgem RIIO-2	NERA (Feb 2024)	NERA (Feb 2024, GDNs)	Comment
Transaction Costs (p6)	6 bps	6 bps	8.5 bps	<ul style="list-style-type: none"> <li>Based on updated companies' data</li> <li>Analysis of GDN data shows reduced tenor increases costs given amortisation of up-front fees over shorter life</li> </ul>
Liquidity/RCF Costs (p7)	4 bps	13 bps	13 bps	<ul style="list-style-type: none"> <li>Both Ofgem and NERA draw on companies' assumptions on RCF size and cost, but we assume 15% of RCF drawn to fund working capital/ operational needs.</li> <li>Increased liquidity cost also reflects higher short-term borrowing rates at RIIO-3</li> </ul>
Cost of Carry (p8)	10 bps	12 bps	12-27 bps (19 bps)	<ul style="list-style-type: none"> <li>Two approaches: (i) companies' cash and debt in latest RFPRs (12 bps), consistent with Ofgem's approach at RIIO-2, and (ii) assume 12-24 month pre-financing, half met by RCF (range 8-16 bps)</li> <li>Cost-of-carry increases as pre-financing costs amortised over shorter bond tenor</li> </ul>
CPIH Premium (p9-14)	5 bps	18-23 bps (21 bps)	18-23 (21 bps)	<ul style="list-style-type: none"> <li>Ofgem recognised CPI switching costs of 5 bps p.a. (30 bps for new CPI debt, and 15bps for switching RPI-CPI, weighted by ILD%)</li> <li>We estimate 30-50 bps p.a. for new CPI issuance using latest nominal-CPI swap costs, and 15 bps p.a. for managing RPI-CPI basis risk. Ofgem does not recognise CPI-CPIH basis risk cost, which we estimate to be 40-50 bps p.a. based on 1 standard deviation.</li> <li>We estimate the total cost for CPIH basis risk mitigation to be 18-23 bps p.a., by weighting the above estimate with 30% ILD, and new/embedded debt respectively</li> </ul>
New Issue Premium (NIP) (p15-19)	0 bps	5 bps	5 bps	<ul style="list-style-type: none"> <li>Latest market evidence supports a 15bps NIP, consistent with CAA for HAL. Multiplying 15bps with 35% assumed new debt% results in ca 5 bps p.a. of NIP.</li> <li>Not addressed as part of this report although we would expect concerns around future use of gas networks to impact NIP</li> </ul>
<b>Additional Cost of Borrowing</b>	<b>25 bps</b>	<b>54-59 bps (57 bps)</b>	<b>57-77 bps (67 bps)</b>	<ul style="list-style-type: none"> <li>Excludes any increase in NIP to reflect heightened risk from decarbonisation of heat</li> </ul>
Small Company/Infrequent Issuer Premia (p20-24)	6 bps	10-18 bps (14 bps)	10-18 bps (14 bps)	<ul style="list-style-type: none"> <li>Lower bound based on the CMS-implied premium, since CMS does not provide risk hedging for credit risk (Ofgem approach)</li> <li>Upper bound based on illiquidity premium estimated using the bid-ask spread differential between sub-benchmark issues and issues at and above £250m</li> </ul>

Source: Nera 'Additional Cost of Borrowing for the RIIO-3 Price Control', February 2024 p2, and Nera 'Impact of GSN's Reduced Debt Tenor on Additional Cost of Borrowing at RIIO-3', February 2024, p2

2.49. The liquidity cost and cost of carry elements of estimates above are based on historical cash holdings and existing licence requirements. In the SSMC, Ofgem proposes to introduce further financial resilience

measures<sup>40</sup>, including proposed amendment to the “availability of resources” condition to require licensees to hold sufficient financial resources to cover the entire price control period or a minimum of three years ahead. Such a change is likely to increase companies’ cost of carry and liquidity costs, which will need to be incorporated in the additional borrowing costs allowance.

### 3. Section 3. Allowed return on equity

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

- 3.1. Our approach to setting the base RIIO-3 cost of equity for energy networks is evidenced in Oxera’s Cost of Equity Report<sup>41</sup>, and results in the following CAPM Cost of Equity Range at 60% gearing of 5.08% to 6.48%. This methodology is aligned with the UKRN recommendations<sup>42</sup>. The asset beta range we present of 0.32–0.37, with a mid-point of 0.349, is consistent with Ofgem’s RIIO 2 range and is an appropriate RIIO-3 energy network baseline beta, before incorporating sector specific and forward-looking risks.

**Table 2: Cost of equity as estimated by Oxera.**

Individual Element	Oxera Low	Oxera High	Oxera Mid
RFR	1.84%	1.84%	1.84%
TMR	6.50%	7.50%	7.00%
Equity Beta	0.70	0.82	0.76
CoE	5.08%	6.48%	5.78%

*Note – The Oxera report needs to be taken in conjunction with the Frontier Equity Investability report which shows that cross checks support a material uplift even to the top end of the cost of equity range. FQ14 covers this ‘equity financeability test’ in more detail.*

Source: Oxera ‘RIIO-3 Cost of Equity’, February 2024 p11-12

- 3.2. As set out in our response to FQ7, whilst Oxera’s report aligns with UKRN<sup>43</sup> Recommendations 2-7 and the underlying guidance, we disagree with some of Ofgem’s proposed interpretation and application in relation to the RFR, TMR and Point Estimate, which are material and are set out and evidenced in our response below.

Furthermore, we set out below why significant weight has to be put on 10 year National Grid betas for GDNs, to incorporate the historical gas activities of National Grid, and explain how uncertainty and risk regarding the future of gas has increased since RIIO-2 and the resultant systematic and asymmetric risks need to be incorporated in the asset beta and cost of equity calculation.

#### Risk Free Rate (RFR)

- 3.3. Compared to Ofgem’s approach in the SSMC, we believe RFR calculation should include the following additional factors – which do not contradict UKRN Guidance<sup>44</sup> on RFR (as set out in section 2.1.4 of the Oxera Report<sup>45</sup>):

<sup>40</sup> See Nera ‘Additional Cost of Borrowing for the RIIO-3 Price Control’, March 2024, Note 1, p3.

<sup>41</sup> Oxera ‘RIIO-3 Cost of Equity’, February 2024

<sup>42</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#)

<sup>43</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#)

<sup>44</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#), p14-p15

<sup>45</sup> Oxera ‘RIIO-3 Cost of Equity’, February 2024

- **Take account of the convenience premium adjustment to the RPI Index Linked Gilts (ILG).** Section 2.1.1. of the Oxera report explains how the convenience premium of RPI ILG typically pushes yields on government bonds down relative to the RFR, the rate at which investors can undertake risk-free borrowing and lending. This is driven due to a high demand for highly rated government bonds which in turn have been driven by regulatory requirements and the benefits of using government bonds in hedging strategies. If Ofgem does not take account of the convenience premium, the RFR assessment may be understated.
- **Utilise inflation swaps.** Inflation swaps should be used as well as Ofgem's 20 year inflation forecast approach to calculate the RPI-CPI wedge. This is in line with the UKRN guidance stating both approaches can be used, as outlined in section 2.1.2 of the Oxera report.
- **Apply a CPI-CPIH wedge:** Section 2.1.2 of the Oxera report also explains how CPIH has historically been below the CPI, and thus why a CPI-CPIH wedge should be applied with the RPI-CPI wedge to convert from the RPI real RFR (RPI ILG plus convenience yield) to a CPIH RFR.

## TMR

3.4. Compared to Ofgem's approach in the SSMC, we believe the following methodologies should be adopted. We also note that they do not contradict UKRN Guidance<sup>46</sup> on TMR, as explained in section 2.2.6 of the Oxera Report<sup>47</sup>;

- **Emphasis on the historical ex-post TMR rather than ex-ante.** Section 2.2.3 of the Oxera Report explains how the ex-ante TMR is a subjective exercise which attempts to estimate the expected future return expectations over historical periods, rather than use ex-post actual returns data.
- **Use of the new Office of National Statistics CPIH backcast data from 1950-1988.** Section 2.2.3 of the Oxera Report explains how this data set addresses concerning errors in the previous CPI backcast series used by Ofgem to deflate historic nominal returns in RIIO-2 and has been adopted by other regulators including Ofwat.
- **Use of the long-term arithmetic mean of one-year returns.** Section 2.2.1 of the Oxera Report explains why sole reliance on the arithmetic mean of historical numbers is more appropriate than also putting weight on the geometric mean, and why nonoverlapping annual holding periods should be used.
- **Recognition that there is some variability in TMR with interest rates:** p8 of the Oxera report sets out how the proposed increase in the TMR from RIIO-2 would be in line with capturing some of the movement in the RFR since RIIO-2 (c.15% of the RFR increase). Frontier's Equity Investability report<sup>48</sup> sets out in detail, in section 2.1.1, how regulators have lowered their estimate of TMR over time explicitly in response to the fall in gilt yields. Allowances which reflected a low interest rate environment in the past must now be adapted to reflect the new conditions in financial markets, as set out in section 2.1.2 of Frontier's report. The RIIO-2 TMR methodology was set in a low interest rate environment and thus it was not an enduring through the cycle approach to be maintained in RIIO-3 and beyond.

## Equity Beta

### Baseline Energy Network Beta

<sup>46</sup> [CoC-guidance\\_22.03.23.pdf \(ukrn.org.uk\)](#), p19-p21

<sup>47</sup> Oxera 'RIIO-3 Cost of Equity', February 2024

<sup>48</sup> Frontier 'Equity Investability in RIIO-3'

3.5. Ofgem's methodology for RIIO-2 was to put more weight on larger samples of data<sup>49</sup>. The Oxera range of 0.32–0.37, with a mid-point of 0.349, is consistent with Ofgem's RIIO2 view and is appropriate for an energy network baseline beta for RIIO-3. This is because, as detailed in Section 2.3.3 of the Oxera report;

- Applying Ofgem's RIIO-2 methodology to the latest market data generates a similar estimate to the one calculated using the Oxera methodology;
- Ofgem, Ofwat and the CMA have all previously expressed a preference for longer-term beta approaches that point to a similar estimate. Any change in approach would need to be justified against this previously held preference and risks signally a lack of regulatory stability and predictability.
- Longer term approaches place less weight on the more recent period of market volatility caused by the impact of the Covid pandemic and the Ukraine war, ensuring that large fluctuations in beta can be avoided.

3.6. There is no reason to expect that the risk of energy networks will have decreased in RIIO-3, either in absolute terms or relative to the wider economy. In fact, with reference to Ofgem's acknowledgement of the 'macro developments' underpinning the industry in the lead-up to RIIO-3 and beyond, it is more reasonable to expect that risks have increased and are expected to increase further on a forward-looking basis.

#### GDN Equity Beta

3.7. Gas beta data points are a significant factor in determining a GDN beta, and thus the historical gas activities of National Grid need to be incorporated in its estimation. As explained in the Oxera RIIO-3 Cost of Equity report<sup>50</sup>, National Grid has gradually divested gas assets, with the sale of stakes in Cadent taking place in 2017 and 2019, and National Gas Transmission (NGT) in 2023. Currently only 10 year betas materially capture National Grid returns data with a GDN (Cadent) incorporated and by December 2025 only 5 and 10 year betas will include betas from when National Grid had a greater share in NGT's ownership. Therefore, significant weight has to be put on 10 year National Grid betas for GDNs.

3.8. For gas networks the uncertainty on the future of gas and the asset stranding risk has notably increased since RIIO-2 final determination, which debt investors have already reflected through gas vs electricity debt premiums and shorter tenors, as detailed in our response to FQ2. Section 2B of the Oxera GDN Risks and Investability report<sup>51</sup> highlights the systematic component of the asset stranding risk and Section 2C highlights the implications of the gas premium in terms of causing a higher asset beta and thus required cost of equity. Section 4B of the Oxera GDN Risks and Investability report highlights international precedents of adjustments to asset beta for asset stranding risk (as well as for asymmetric risk as detailed below), which is summarised in para 4.72 of the report.

3.9. Further market evidence supporting there being an investor perception of asset stranding risk, and how the systematic element of this is reflected in the asset beta, is detailed in section 3 of the Oxera GDN Risks and Investability report. This shows how the 2, 5 and 10 year asset betas of gas networks have been, on average, 0.02–0.04 higher than those of electricity networks at least since 2019, based on a sample of European networks. This analysis and constitutes supportive evidence of the systematic nature of the asset stranding risks.

<sup>49</sup> RIIO-2 Final Determinations – Finance Annex (REVISED) (ofgem.gov.uk), para 3.74

<sup>50</sup> Oxera 'RIIO-3 Cost of Equity', February 2024

<sup>51</sup> Oxera 'Risks and investability of the GB gas distribution sector', paras 2.22-2.26

[REDACTED]

[REDACTED]

[REDACTED]

#### Point Estimate

- 3.11. The UKRN Guidance<sup>52</sup> states there must be clear and convincing evidence to support a cost of equity set above a reasonable mid-point, which shows it is in consumer interests and that there needs to be an assessment that existing regulatory mechanisms cannot address the need to aim up from the mid-point. We believe there are a number of factors that lead to aiming up on this basis;
- **the low beta anomaly:** as set in Oxera's RIIO-3 Cost of Equity<sup>53</sup> Report, the single factor CAPM has been shown to underestimate the market returns for low beta stocks such as regulated utilities.
  - **asymmetric risk: as set out in Oxera's GDN Risks and Investability report<sup>54</sup>**
    - Asset stranding risk has an asymmetric as well as the systematic component detailed above. An asymmetric risk occurs whenever a specific (material) risk introduces a negative asymmetry in the range of expected outcomes. This asymmetry is present in scenarios of significantly declining gas volumes<sup>55</sup>. There is no expectation that Ofgem will allow over-recovery of allowed revenues—but in the absence of a RAV guarantee, Ofgem is unable to ensure that there will never be under-recovery. As a result, the asymmetry of potential outcomes arises.
    - Cash-flow remedies, such as accelerated depreciation and re-openers, which Ofgem is considering using to address the asset stranding risk in RIIO-3, do not eliminate the risk. This is because uncertainty around networks' future ability to recover their costs remain.
    - As with any other asymmetric risk within a regulatory regime, the asset stranding risk implies a downward pressure on the expected returns. Investors bearing the risk cannot expect to earn the headline allowed return on a probability-adjusted basis. Hence, either the risk should be addressed directly by a RAV guarantee, or an appropriate uplift should be applied to the allowed return to avoid under-compensation and to maintain a fair and balanced return expectation, which is key for ensuring the quality of service and investability within the industry.
    - Contrary to the implications of para 8.15 of the SSMC, compensation for asset stranding risk is not a double count of the risk if a RAV guarantee is not implemented. It would be a compensation for the risk not mitigated by a change in depreciation policy, as detailed in paras 4.7-4.10 of the Oxera GDN Risks and Investability report. France and New Zealand are two examples of countries where both depreciation policy changes (resulting in cash-flow acceleration) and a cost of capital uplift or ex ante allowance have been implemented to address the asset stranding risk.
    - Indeed, as highlighted in para 2.11 of the Oxera GDN Risks and Investability report, Ofgem has recognised the need to take into account the expected outcome of the entire price control when setting the allowed return;

<sup>52</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#), p27

<sup>53</sup> Oxera 'RIIO-3 Cost of Equity', February 2024, p66.

<sup>54</sup> Oxera 'Risks and investability of the GB gas distribution sector', section 2A

<sup>55</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 1.7.

*‘the skew of incentives in the price controls could be set in a way which would result in the expected return on equity for an efficient licensee being higher or lower than our estimate of the cost of equity. [...] we may need to adjust the allowed return on equity such that expected returns match our best estimate of the cost of equity.’*

- There is significant UK regulatory precedent supporting an adjustment to the allowed return for asymmetric risk, as detailed in para 2.12 of the Oxera GDN Risks and Investability report.
- Section 4B of the Oxera GDN Risks and Investability report highlights international precedents of adjustments to the allowed return for asymmetric risk (as well as adjustments to asset beta for the systematic component of asset stranding risk, as detailed above).

### Investability Cross Checks

3.12. In principle, SGN believe that Ofgem are correct in considering cross checks to the CAPM derived cost of equity estimate, as equity investability needs to be tested. However, we believe there are two approaches to investability tests which will capture a wider range of cross checks:

1. **Debt Based Investability Tests.** Safeguarding equity investability requires that the cost of equity lies sufficiently far above the long-term return on senior investment-grade debt, due to their relative risk profiles, as set out in Frontier’s Equity Investability report<sup>56</sup>. Both Frontier and Oxera have developed cross checks to reflect the incremental return that equity requires over debt;
  - hybrid bond cross check: hybrid bonds are securities that combine debt and equity characteristics. Since the yield on these hybrid bonds is directly observable, with an appropriate assumption on the proportion of equity like feature of the hybrid bond, an expected return on equity can be implied from a relatively simple formula. This cross check and its findings are set out in detail in Frontier’s Equity Investability report<sup>57</sup>.
  - ARP-DRP cross-check: this compares the difference between the ARP (the expected excess return from holding risky assets compared to riskless assets) and the debt risk premium (DRP, the expected excess return to holding risky debt relative to riskless assets). This cross check and its findings are set out in detail in Oxera’s Cost Equity report<sup>58</sup>.

As stated in para 14 of Frontier’s report, evidence from hybrid bonds indicates that the cost of equity should fall in the range 5.8% to 8.5%, with a central estimate of 6.7%. This finding is closely corroborated by Oxera’s ARP-DRP cross check, which we understand supports a Cost of Equity point estimate that is close to the upper end of Oxera’s recommended CAPM range (6.48%).

2. **Equity Based Investability Tests:** these infer the Cost of Equity from wider market evidence and include Frontiers Long term profitability benchmarking cross check as well as those used by Ofgem at RIIO-2. These cross checks are set out in detail in section 6 of Frontier’s report. Frontier believe less weight should be placed on Equity based cross checks as they are *‘...inevitably harder to develop, as available equity returns are by their nature unobservable’*<sup>59</sup>, but state, in para 10 of their report, that there is merit in considering what these cross checks now show in RIIO-3 and whether they support moving allowed returns back up.

<sup>56</sup> Frontier ‘Equity Investability in RIIO-3’, March 2024, paras 6 & 7

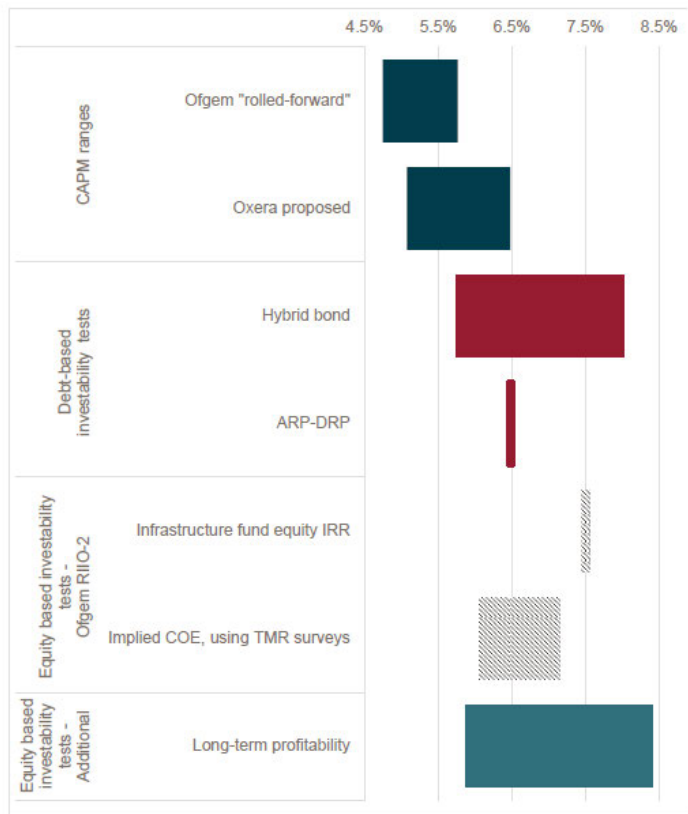
<sup>57</sup> Frontier ‘Equity Investability in RIIO-3’, March 2024, section 5

<sup>58</sup> Oxera ‘RIIO-3 Cost of Equity’, February 2024, Section 3

<sup>59</sup> Frontier ‘Equity Investability in RIIO-3’, para 41

The chart below compares the Debt and Equity Based Investability Tests with Oxera’s proposed RIIO-3 Cost of Equity Range and a Cost Equity based on rolling forward Ofgem’s RIIO-2 methodology<sup>60</sup>.

Figure 1: Frontier report



In summary, market evidence shows that a Cost Equity range derived from a simple roll forward of Ofgem’s RIIO-2 approach (4.75%-5.77%) will determine a cost of equity range that is too low – such a price control would not be investable. Even a number from the very top of that range would fail investability tests.

Frontier also concludes in para 18 of their report that these cross-checks show that;

*‘...an appropriate allowed CoE is likely to be at least in line with the top end of Oxera’s estimated RIIO-3 range (i.e., 6.48%) – and if anything higher than this (i.e., 6.48% tends to be the lower end of the range implied by our suite of tests). This is consistent with Oxera’s view that the approach it has adopted may not yet capture all relevant risks, and that some further uplift to beta may be necessary’.*

<sup>60</sup> The executive summary of Oxera’s ‘RIIO-3 Cost of Equity’ report, March 2024, contains detail of the methodology they use to assess the CoE estimate that Ofgem would set in RIIO-3 if it rolled forward the RIIO-2 methodology.



It should be noted that the Cost of Equity vs Cost of Debt cross checks were carried out relative to the iBoxx Utilities index and therefore should take into account the gas vs debt premium when considering the appropriate allowed CoE for GDNs.

#### Further Evidence

- 3.13. The future of gas and the uncertainty surrounding it is an evolving area. We will continue look at risk implications and their impact on the GDN cost of equity, through systematic and asymmetric risk, over the coming months, together with the ongoing work on equity investability tests that Frontiers report presents.

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

- 3.14. **Overall, we do not believe there are good reasons to deviate from the respective approaches set out under UKRN Recommendations 2-7, at this early stage in the RIIO-3 process. However, as noted in our response to FQ6, we disagree with some of the ways Ofgem are proposing to interpret and apply the UKRN Recommendations and Guidance. The Oxera report recommends some alternative approaches to interpreting and applying the UKRN Recommendations and Guidance, whilst being compliant with them.**
- 3.15. Whilst recommending some alternative approaches to interpreting and applying the UKRN Recommendations and Guidance, Oxera's approach is compliant with the UKRN recommendations and guidance as set out in their RIIO-3 Cost of Equity report<sup>61</sup>. They state their approaches to RFR, beta and TMR are compliant, noting that as recommended by the UKRN, they provide the TMR estimates based on both historical ex post and ex ante TMR approaches. However, they do not consider the historical ex ante approach to be reliable and thus they put little weighting on it when deriving a reasonable TMR range.
- 3.16. They consider that appropriate in the context of
- "the UKRN guidance that recommends using primarily these two approaches. The main reason is that market conditions have changed since the guidance was developed (rather than finalised and published)—interest rates have surged. In this context, as noted by the UKRN, it may be reasonable to revise regulatory practice. We therefore consider that, irrespective of the methodological reasoning, the historical ex ante approach produces estimates incompatible with the changed market environment"*<sup>62</sup>

### 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?

**The high level UKRN recommendation (3) on RFR does not cover how to convert RPI-real yield to CPIH real inputs, but the more detailed Guidance recommends that long run inflation forecasts or inflation swaps**

<sup>61</sup> Oxera 'RIIO-3 Cost of Equity', February 2024, Section 3

<sup>62</sup> Oxera 'RIIO-3 Cost of Equity', February 2024, Section 2.26



should be used to adjust RPI-real yields to CPIH-real<sup>63</sup>. It is important that Ofgem takes account of what is stated in the Guidance section for each parameter as well as the high level recommendations. Furthermore, as per the RFR section of our response to FQ6, a CPI-CPIH differential should also be applied be reflected in the calculation of the RPI-CPIH wedge.

**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?**

We set out below why significant weight has to be put on 10 year National Grid betas for GDNs, to incorporate the historical gas activities of National Grid. This sets an initial baseline, however, for gas networks the uncertainty on the future of gas and the asset stranding risk has notably increased since RII0-2 final determination, which debt investors have already reflected in gas vs electricity debt premiums and shorter tenor. We explain why the associated systematic and asymmetric risks need to be overlaid on top of long term betas, in the asset beta and cost of equity calculation, to capture this forward looking risk.

- 3.17. In the RFR, TMR and Baseline Energy Network Beta sections of our response to FQ6 we set our approach to setting the base RII0-3 cost of equity for energy networks, as evidenced in Oxera's Cost of Equity Report<sup>64</sup>. This excludes sector specific and forward looking risks.
- 3.18. As set out in the GDN Equity Beta section of our response to FQ6, historical gas beta data points are a significant factor in determining an initial GDN beta, and thus the historical gas activities of National Grid need to be incorporated in its estimation. Due to the timing of National Grid's gas asset sales this means significant weight has to be put on 10 year National Grid betas for GDNs. Long term National Grid betas, and the consequent Cost of Equity point estimate, then have to be adjusted for the forward looking risks highlighted below.
- 3.19. For gas networks, uncertainty on the future of gas and asset stranding risk has notably increased since RII0-2 final determination. Debt investors have already reflected this risk through gas vs electricity debt premiums and shorter tenors, as detailed in our response to FQ2. Section 2B of the Oxera GDN Risks and Investability report<sup>65</sup> highlights the systematic component of the asset stranding risk and Section 2C highlights the implications of this gas premium in terms of causing a higher asset beta and thus required cost of equity. Section 4B of the Oxera GDN Risks and Investability report highlights international precedents of adjustments to asset beta for asset stranding risk (as well as for asymmetric risk as detailed below), which is summarised in para 4.72 of the report.
- 3.20. Further market evidence supporting there being an investor perception of asset stranding risk, and how the systematic element of this is reflected in the asset beta, is detailed in section 3 of the Oxera GDN Risks and Investability report. This shows how the 2, 5 and 10 year asset betas of gas networks have been, on average, 0.02–0.04 higher than those of electricity networks at least since 2019, based on a sample of European networks. This analysis and constitutes supportive evidence of the systematic nature of the asset stranding risks that need to be captured in the GDN asset beta.
- 3.21. The point estimate section of our response to FQ6 details how asset stranding risk has an asymmetric as well as the systematic component detailed above. As summarised in Oxera's GDN Risks and Investability report<sup>66</sup>

<sup>63</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#), March 2023, p15

<sup>64</sup> Oxera 'RII0-3 Cost of Equity', February 2024

<sup>65</sup> Oxera 'Risks and investability of the GB gas distribution sector', paras 2.22-2.26

<sup>66</sup> Oxera 'Risks and investability of the GB gas distribution sector', p4&5

*‘whenever a specific (material) risk introduces a negative asymmetry in the range of expected outcomes and/or has systematic characteristics—i.e., is correlated with the wider economy—this provides a reason to account for this risk in the allowed return on equity.*

*Cash-flow remedies, such as accelerated depreciation and re-openers, which Ofgem is considering using to address the asset stranding risk in RIIO-3, are useful in mitigating the risk. However, they do not eliminate it, because uncertainty around networks’ future ability to recover their costs remains—for example, due to customer bills having to increase to an untenable level, especially if the user base shrinks in the future. Therefore, an uplift to the allowed return on equity relative to the ‘baseline’ allowance for a steady-state GB energy network would be justified’.*

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

- 3.23. Notwithstanding the important points above of why and how long term National Grid Betas need to be used to determine a GDN beta; even if a representative short term beta data was available for GDNs it is unlikely at this time the beta would be starting to represent forward looking risks. This is due to the recent high volatility (in a period affected by the Covid-19 pandemic and Russia’s invasion of Ukraine) and the estimation issues this causes. This point is detailed in Frontier’s ‘Low Beta Puzzle’ report<sup>67</sup>, along with why the high equity risk premium usually experienced in times of high market volatility would not be captured by the current prevailing regulator approach to setting the Cost of Equity in the UK, as regulators have preferred to assume the TMR is stable (albeit not fixed).

#### **Further Evidence**

- 3.24. The future of gas and the uncertainty surrounding it is an evolving area. We will continue to look at risk implications and their impact on the GDN cost of equity, through systematic and asymmetric risk, over the coming months, together with the ongoing work on equity investability tests that Frontiers report presents.

## **4. Section 4. Allowed WACC**

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

- 4.1. **In principle we agree with Recommendation 1 that regulators should estimate the allowed return based on notional company WACC for the sector. However, a partial departure would be required for Cost of Debt inflation options 1 and 2, as detailed below.**

<sup>67</sup> Frontier ‘Low Puzzle Beta’ report, March 2024

- 4.2. **With regards to Recommendation 9 (regulator assessment of notional gearing) we believe the guidance should be enhanced so the most relevant factors are considered, namely, an assessment of actual companies' levels of gearing, impact assessments of any proposed change from RIIO2 and assessing the drivers behind any proposed change and whether these should be addressed at source.**
- 4.3. In principle we agree with recommendation 1 that “regulators should continue to estimate the allowed rate of return in price controls based on the WACC for a notional company within their sector”<sup>68</sup>. However, a partial departure would be required for Cost of Debt inflation options 1 and 2. As set out in our response to FQ3 networks over time have adopted company specific capital structures based on the notional company at the time, which would take many years to unwind to avoid substantial costs of restructuring current debt. Therefore, the Index Linked Debt (ILD) portion should be based on each company's actual ILD portion (including index linked derivatives). Varying the ILD portion for each company will mean variances in the real WACC by network. But this is necessary to avoid networks having inflation exposure impacting their financial resilience in a manner that could not have been anticipated when they made their capital structure decisions, an issue recognised by Ofgem<sup>69</sup>.
- 4.4. Recommendation 9 states;
- ‘The notional gearing assumption should reflect the regulator’s assessment of the balance of risks facing the regulated company, a wide range of benchmarks on gearing levels and overall regulatory policy objectives, not just that of the actual company (or companies) in question.’<sup>70</sup>*
- 4.5. SGN believe the guidance should be enhanced so the most relevant factors are taken into account when assessing notional gearing at each price control, namely;
1. an assessment of the actual companies gearing levels which gives a good objective indication of the efficient capital structure for the industry. A notional gearing significantly below sector-average could impair financeability tests and make the results of these tests less informative.
  2. an impact assessment of any proposed change in notional gearing– we note this was not done when the GDN notional gearing dropped from 65% in RIIO-1 to 60% in RIIO-2.
  3. an assessment of the drivers behind any change in gearing and whether these should be addressed at source – for example has the cost of equity been set using appropriate methodology and been subject to an equity financeability test.
- 4.6. We note that in para 4.10 of the finance annex, Ofgem state, “we currently expect *gearing levels to remain consistent with those used in RIIO-2. However, this will be subject to the confirmation of company specific investment plans.*” SGN would like to clarify the basis on which this confirmation would be carried out and the basis on which networks would be informed.
- 4.7. Para 4.9 references a number of factors that Ofgem would take into consideration when forming its view that include the anticipated pace and quantum of investment, market commentary and the availability of the equity vs debt. These factors are very subjective, and for such an important variable in the assessment of financeability it is important that any changes are made through a defined framework and at a defined time.

<sup>68</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#), p11

<sup>69</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 2.45.

<sup>70</sup> [CoC-guidance 22.03.23.pdf \(ukrn.org.uk\)](#), p33

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?

- 4.8. **As detailed in our response to FQ10, we believe the most relevant factors when assessing notional gearing are assessment of actual companies' levels of gearing, impact assessments of any proposed change from RIIO2 and assessing the drivers behind any proposed change and whether these should be addressed at source. We currently believe there is no evidence to deviate from the RIIO2 assumptions.**
- 4.9. The latest Regulatory Financial Performance Reporting packs (2022/23) show the GDN actual gearing averages over 60%. Adopting a notional gearing below sector average could impair financeability tests and make the results unreliable. We currently believe there is no evidence to deviate from the RIIO2 assumptions.

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 statement in para 4.11 of the Finance Annex that *'it may be more intuitive to assume that the notional capital structure remains constant in each year of the price control and that variables such as net issuance of debt and equity are varied in order to achieve this'*. However, we think this should be further considered and consulted on once an initial Business Plan Financial Model has been populated and again when the price control calibration is known.

## 5. Section 5. Financeability

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

- 5.1. It is important for the financeability assessment to be designed in such a way that it can provide meaningful information about a sector's ability to raise debt financing on efficient terms and its links to equity investability. Given the significant uncertainty surrounding the future of gas networks and significant macro-economic uncertainty - a number of important changes to the financeability assessment need to be considered including; (i) extending the assessment horizon beyond RIIO-3, (ii) undertaking a more rigorous risk assessment by developing robust downside scenarios, (iii) considering how credit agency views may evolve and (iv) linkage to equity investability. Finally, any changes in notional company assumptions from the previous price control need to be fully justified and subject to an impact assessment.
- 5.2. **Ofgem has a legal statutory duty to have regard to the need to secure that companies are able to finance their activities . The assessment therefore must be investigated robustly recognising the statutory importance of the issue and the potential changes for GDNs over the next 20-30 years.**
- Extending the time horizon beyond RIIO-3**
- 5.3. In the Finance Annex (para 5.14) Ofgem raises the possibility of considering a longer-term perspective in the assessment of financeability. Given the importance of funding the future energy scenarios and the

perception of risk around asset stranding and limitations on cost recovery that could occur in future energy scenarios, we agree it is important to extend financeability beyond RIIO 3.

- 5.4. There is a risk that not extending the analytical timeframe accordingly across suitable scenarios could result in the RIIO-3 decisions being made (or not made) without understanding the full magnitude of their consequences such that Ofgem has not taken the steps required to equip itself with the information to correctly assess financeability. These consequences include the impact on customer value and bills, GDNs' financial resilience and, importantly the perceived robustness of the regulatory framework underpinning the RAV. This would not be in anyone's, not least the consumers' best interests.
- 5.5. A longer-term perspective on financeability would be consistent with Ofgem's consideration of equity returns through the economic cycle (e.g., stable TMR). For the GDNs specifically, it is important to take into consideration the asset stranding and operational cost recovery risk that could materialise under the FES scenarios.
- 5.6. Credit rating agencies also opined that an extension of the financeability horizon would be a positive development, which would be aligned to their view of a supportive regulatory framework<sup>71</sup>.
- 5.7. We recognise that it is difficult to model beyond the next price control due to the significant uncertainties over future regulatory framework, which can have a material impact on cashflows. Scenario analysis could help overcome this challenge with a longer-term assessment based on higher-level modelling of key drivers with clear assumptions for a range of scenarios. The timeframe of financeability analysis should be aligned with that of risk analysis and the longer-term perspective should consider a range of factors including the ability of companies to obtain longer-term tenor debt and debt maturity profiles.

**Rigorous risk assessment by developing robust downside scenarios.**

- 5.8. SGN also recognise that the FES scenarios are widely considered within Ofgem's decision making and to inform government scenarios. As we set out within the introduction to this Annex, SGN do not consider there to be sufficient market evidence to suggest that these scenarios are robust, however government policy can change. We recognised that the FES scenarios only provide an assessment of the decarbonisation pathway and are not sufficient in isolation. In order to ensure that outcomes are proportionate and evidence-based, they will need to be complemented with an appropriate downside assessment of macro-economic environment. These should be based on plausible ranges for items such as inflation and interest rates. Without a defined approach to the testing of downside scenarios there is a risk the assumptions that are not carefully considered become arbitrary and lose their effectiveness.
- 5.9. In particular, in order to assess financeability in a way that can provide meaningful information about a sector's ability to raise debt financing on efficient terms;
  - Ofgem must undertake a more rigorous risk assessment by developing robust scenarios informed by the evidence of most material risks. This risk assessment should be undertaken using well justified scenarios rather than arbitrary assumptions and the analysis should be informed by both top-down and bottom-up risk assessment. A top-down approach would consider past performance at a sector and company specific level and a bottom-up analysis would consider potential risks and assessing impacts on a forward-looking basis. We are happy to work with Ofgem to develop these scenarios.
  - The risk assessment should consider the impact of all risks including the asymmetric ones, after taking account of regulatory risk reduction mechanisms. RoRE exposures under separate risks should also be translated into plausible combination scenarios, considering the extent of correlation between risk events.

<sup>71</sup> KPMG 'Credit Rating Agencies' perception of Risk for Gas Distribution Networks (GDNs) under RIIO-3 and beyond', March 2024

- For GDNs specifically, risk analysis should consider the clearly evidenced risk that is associated with different pathways to net zero and different mitigating options proposed by Ofgem. This analysis will provide a necessary insight into potential financeability challenges that GDNs may face in 10-15 years, and which need to be considered in today's decision-making.

- [REDACTED]

- 5.10. A long-term financeability assessment should be undertaken on the basis of the notional company operating in the gas distribution sector and should factor in the long-term impact of uncertainty on the cost, tenor, and availability of different types of debt financing in the context of ongoing investment and refinancing requirements as these could also pose financeability risks but not be captured by the standard credit rating agency ratios.

#### **Considering the evolution of the credit rating agency (CRA) views**

- 5.11. SGN consider the factors that need to be assessed over the longer-term in order to inform RIIO-3 decisions include customer value and bills, GDNs' financial resilience, the perceived robustness of the regulatory framework underpinning the RAV and the evolution of CRA views.
- 5.12. It would be beneficial if Ofgem set out target credit metrics with greater definition – i.e., specifying a particular credit rating level or acceptable band of credit ratings.

[REDACTED]

[REDACTED]

#### **Linkage to equity investability**

- 5.14. As set out in FQ14, we believe equity investability tests compliment the current debt focused financeability assessment.

#### **Rationale for Change of Financeability Assumptions**

- 5.15. Any changes in notional company assumptions from the previous price control need to be fully justified on the evidence and subject to an impact assessment. The impact assessment is required to look at how any change in notional company can be expected to impact the behaviours of actual companies as they seek to maintain their financeability. The lack of an impact assessment undermines whether the test is meaningful and whether it robustly tests that the price control package is appropriately calibrated. There is a risk that a poorly calibrated package would lead to unintended consequence of either over or under rewarding network companies, with consequent implications for consumers and financeability.

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

- 5.16. We welcome Ofgem's intention to develop the notion of investability in the SSMC (welcoming the increased emphasis on investability, while noting that Ofgem should always be seeking outcomes where networks can obtain necessary investment). Equity financeability (investability) must focus on assessing whether the equity return proposed by Ofgem is competitive versus the other opportunities that exist in the wider capital market. We believe investability improves the financeability assessment, providing the potential to serve the equity investor in the same way that financeability serves the debt investor (i.e., by testing whether a notional licensee can service reasonable debt costs and maintain financial metrics).
- 5.17. Investability is critical to RIIO3 because.
- there have been material changes to the capital market conditions since RIIO2 was set.
  - all Networks will face huge challenges and heightened risk in RIIO-3 due to the transition to net zero.
- 5.18. Although Ofgem appears to have been motivated in its discussion on investability by the pace of growth anticipated for electricity networks, investability is as much a challenge for gas networks. This is due to the need to retain existing equity as well as attract new equity investment to maintain safety and security of supply in the context of significant downside and uncertainty over the future of gas, the impact of which we are already seeing in debt market spreads and tenor decisions as highlighted in our response to FQ2.
- 5.19. Notwithstanding these key points - not considering the investability of a sector with significant uncertainty and risks over its future will directly impact the appetite and cost of investment in other UK energy regulated sectors as investors will tend to assess investability across the whole life cycle of their investment.
- 5.20. Safeguarding equity investability requires that the cost of equity lies sufficiently far above the long-term return on senior investment-grade debt. A Frontier report<sup>72</sup> and Oxera report<sup>73</sup> submitted with this response clearly demonstrate with evidence that rolling forward RIIO2 cost of equity only updating for the latest information on gilt yields, would mean RIIO-3 is not investable. Therefore, changes are required to the RIIO-2 Cost of Equity Methodology as set out in our response to FQ6. Investability also needs to be appropriately defined.
- 5.21. Ofgem raises the topic of investability, specifically equity financeability, in the context of the significant investment required for Electricity Transmission (ET) networks<sup>74</sup>.
- 5.22. Investability is as much a challenge for gas networks as for the electricity transmission networks. This is due to the need to remain competitive, versus the other opportunities that exist in the wider capital market. This is vital in order to retain and attract equity investment to maintain safety and security of supply in the context of significant risk and uncertainty over the future of gas, and thus the recovery of RAV and other future costs including decommissioning. [REDACTED]

<sup>72</sup> Frontier 'Equity Investability in RIIO-3', March 2023

<sup>73</sup> Oxera 'RIIO-3 Cost of Equity', February 2024

<sup>74</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/riio-3-sector-specific-methodology-consultation-finance-annex), paras 1.6.



- 5.23. We are already seeing the impact of this risk and uncertainty in debt market spreads and tenor decisions (please refer to our responses to FQ1 & 2). The Equity Beta and Point Estimate sections of our response to FQ6 set out how this risk uncertainty and risk needs to be reflected in the cost of equity.
- 5.24. Safeguarding equity investability requires that the cost of equity lies sufficiently far above the long-term return on senior investment-grade debt, and Cross checks provide a mechanism to apply this test - as per the Cost of Equity vs Cost of Debt Investability Tests detailed in our response to FQ6.
- 5.25. In para 1.6 of the Finance Annex, Ofgem set out that investability is the requirement for network companies “to seek ‘fresh’ equity from their investors over and above what they would be able to fund via retained earnings”.
- 5.26. We do not think that the requirement to fund over and above retained earnings is a basis from which to measure investability. Investors in any asset class put aside their money to earn a return through interest or dividend payments. They will be willing to reinvest these dividend payments, retained earnings, if they are comfortable that by reinvesting that they will generate a higher return than would be anticipated by taking a dividend and investing it elsewhere. There should be no presumption that dividends will be invested and the requirement to seek fresh equity is an invalid distinction.

**Further Considerations of Why Investability is an equally important issue for gas networks.**

- 5.27. In the context of the risks and uncertainty for gas networks, as detailed in the confidential KPMG report on credit Rating Agencies Perception of Risk for GDNs<sup>75</sup>, applying investability to GDNs would be considered positive by credit rating agencies. This is because it would enable GDNs to attract the right funding and investors on both the equity and debt side, and also provide a stronger alignment between the regulation and appetite for markets to fund the sector.
- 5.28. These points will need the underpinning and active support of shareholders to provide direction for the business, funds as required and provide confidence to debt providers that their portfolios will be remunerated. These challenges, and the support required, further demonstrate that equity investability is a key concern for gas as well as electricity networks. Introducing investability solely for the electricity sector would not be reasonable, and as stated in in Oxera GDN Risks and Investability report<sup>76</sup>;

*“For the sector to be investable, shareholders need to have sufficient confidence that equity that is retained or injected into the business is being remunerated in accordance with the risks that it faces. This is consistent with the government’s strategic energy policy goals, which highlight the need for gas networks to be prepared for the transition to a low-carbon future, taking into account a range of decarbonisation pathways and potential decommissioning costs”.<sup>77</sup>*

- 5.29. Furthermore, the Oxera report states the government also highlights the vital role that gas networks will play in the transition, and that these policy goals require gas specific risks to be addressed and appropriate remuneration<sup>78</sup>:

<sup>75</sup> KPMG ‘Credit Rating Agencies’ perception of Risk for Gas Distribution Networks (GDNs) under RII0-3 and beyond’, March 2024, section 1.3.8

<sup>76</sup> Oxera ‘Risks and investability of the GB gas distribution sector’, March 2024, paras 5.4 & 5.5

<sup>77</sup> [Draft Strategy and Policy Statement for Energy Policy in Great Britain \(publishing.service.gov.uk\)](https://publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/123456/Draft_Strategy_and_Policy_Statement_for_Energy_Policy_in_Great_Britain.pdf), p. 17

<sup>78</sup> Oxera ‘Risks and investability of the GB gas distribution sector’, March 2024, paras 5.5 & 5.6



*“[...] the natural gas system plays a vital role in our energy mix, including contributing towards security of supply. The continued resilience of necessary infrastructure remains a key priority in order to maintain our safe, efficient and reliable gas networks”.*

#### **Interdependence between investability and financial resilience**

- 5.30. As highlighted in Oxera’s report on GDN Risks and Investability<sup>79</sup> it is important to note there is an interdependence between investability and financial resilience;
- 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 would be at risk.
  - neither financial nor operational resilience can be assured through licence obligations alone, as capital will enter and stay only where the network is investable—i.e., where it earns sufficient risk-adjusted returns.
  - Ofgem itself links the notion of investability and financial resilience in the SSMC Finance Annex;
 

*‘consumers and wider society stand to face greater loss if poor financial resilience is a material reason for non-delivery or late delivery.’<sup>80</sup>*

#### **Interdependence between of perceived investability between sectors**

- 5.31. Notwithstanding these key points - not considering the investability of a sector with significant uncertainty and risks over its future will directly impact the appetite and cost of investment in other UK energy regulated sectors, i.e., their investability, as also highlighted in Oxera’s GDN Risks and Investability report<sup>81</sup>.
- 5.32. Therefore, investability cannot be seen as relevant only when sectors have a growing RAV, as investors will tend to assess investability across the whole life cycle of their investment. Ofgem need to be very careful to not damage investor confidence by sending the signal that once their investment has been sunk, they do not see it necessary to compensate at the required rate of return. Investors would quickly see through this type of structure. This point is further detailed in Frontier’s Equity investability report<sup>82</sup>.
- 5.33. Frontier also set out, in para 105 of their report, how Ofgem have already acknowledged that it would be wrong to try and set differential rates of return on equity for new and retained equity – in its Future Systems and Network Regulation consultation decision.
- 5.34. Finally, as set out in Oxera’s report<sup>83</sup>, although Ofgem rightly proposes that investability encompasses an expanded role for ensuring the ability to raise sufficient equity capital on reasonable terms, it does not preclude the importance of ensuring access to debt capital on reasonable terms. GDNs’ have started to experience constraints on raising long-term debt and are experiencing premium vs the iBoxx utilities index and other sectors. Therefore, in addition to the current approach to debt financeability testing, which focuses on credit rating estimation, Ofgem would benefit from a framework that tests whether GDNs are able to ‘attract and retain’ debt capital.

<sup>79</sup> Oxera ‘Risks and investability of the GB gas distribution sector’, March 2024, para 5.9 & 5.11

<sup>80</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 1.12.

<sup>81</sup> Oxera ‘Risks and investability of the GB gas distribution sector’, March 2024 paras 5.12 & 5.13

<sup>82</sup> Frontier ‘Equity Investability in RIIO-3’, para 5

<sup>83</sup> Oxera ‘Risks and investability of the GB gas distribution sector’, March 2024 paras 5.14 & 5.15

5.35. In terms of design, Frontier's report<sup>84</sup> concludes, with reference to the investability tests in Figure 1 of its report (shown in para 3.12 of our response):

1. A Cost of Equity range derived from a simple roll forward of Ofgem's RIIO-2 method (4.75%-5.77%) fails all of the investability tests.
  - i. This would be the case even if Ofgem were to pick a number from the very top of such a range, as this would still sit below the very bottom of the range of Cost of Equity inferred from any of the investability tests.
  - ii. A number selected from the centre of this range would fail all these investability tests by a considerable margin.
2. In contrast, the top end of Oxera's estimated RIIO-3 cost of equity range – is much more in line with evidence from our investability tests, albeit that this tends to be the lower end of the range implied by our suite of tests. This is consistent with Oxera's view that the approach it has adopted may not yet capture all relevant risks, and that some further uplift to beta may be necessary.
3. Despite the fact our investability tests in figure 1 of the report are very different in nature, the results from them line up well and are mutually supportive.
4. The investability checks we have presented confirm that changes are needed to Ofgem's RIIO-2 CAPM methodology. On the basis of the evidence presented above, it would be wrong and irrational for Ofgem to simply roll RIIO-2 forward, updating it only for the latest information on gilt yields. A price control so calibrated would not be investable. It would fail to reflect profound changes in capital markets since RIIO-2 and heightened risk.

5.36. The changes required to the RIIO-2 cost of equity methodology, for RIIO-3, are set out and evidenced in our response to FQ6. These include taking into account in the RIIO-3 methodology that the;

- RIIO-2 TMR methodology was set in a low interest rate environment, and thus it was not a through the cycle approach that should not be revisited for RIIO-3
- GDN Equity beta and Cost of Equity point estimates need to incorporate the increasing risks and uncertainties facing GDNs, with regards to asset standing and cost recovery risk. This is both in terms of systematic and asymmetric risk, which debt investors have already reflected in gas vs electricity debt premiums and shorter tenors.

## 6. Section 6. Financial resilience

**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?**

6.1. **SGN take financial resilience very seriously and note there are already extensive licence requirements that network energy companies must comply with. We are not aware of any financial resilience concerns amongst network energy companies despite the financial crash of 2008 and turmoil over recent years. Whilst we understand the need for the regulator to maintain vigilance and look at best practice, it is also important that any changes proposed provide value for money and the benefits to consumers outweigh the costs of implementing the change. We do not believe this has been assessed and currently we think the costs of the proposed changes will outweigh any benefits and are therefore disproportionate.**

<sup>84</sup> Frontier 'Equity Investability in RIIO-3', para 17 & 18

6.2. [REDACTED]

6.3. **In terms of other measures, we would propose, we believe consistency in targeting a certain financial resilience threshold would be improved if a correct / comparable type of rating is used across companies. Specifically, we believe that the senior debt rating (rather than the IDR) would be a more appropriate rating to monitor, to factor in recovery considerations and to allow better comparison with the ratings of other agencies (where rating definitions may vary).**

6.4. As set out in the SSMC there are already extensive licence financial resilience requirements that energy companies have complied with and there have been no financial resilience concerns across network energy companies despite the major financial crash of 2008, the covid pandemic and the Ukraine War. To the best of our knowledge network companies have shown themselves to be financially responsible and resilient, as supported by paras 6.8 and 6.9 of the SSMC finance annex.

6.5. Whilst we appreciate that a regulator '*should always be vigilant and look at best practice*' (para 6.5 of the SSMC finance annex) it is unclear what the reasons are for the proposed changes or what market failure the changes are targeting to address. The introduction of any new regulation should, following good regulatory practice, be proportionately targeted only where action is needed for a specific market or regulatory failure. Existing failures should first be identified and then an impact assessment made considering the proposed remedy before introducing new regulations.

6.6. Ofgem should be clear about the potential for failure, give an indication as to why the risk of that failure has changed and why it is felt that an intervention is necessary to mitigate that risk and that Ofgem's current tools do not address its concerns. This should then be supported with an impact analysis of its proposals.

6.7. There are references to potential issues that could occur, but these could equally have occurred anytime in the last 20 years but have not and with on-going sensible regulation of the sector there is no reason to consider these hypothetical events to be more likely now.

6.8. There are references to the changes made in the energy retail sector but as acknowledged in the SSMC, the risk profile of the retail sector is vastly different and therefore it is not an evidential basis to justify introducing distribution sector changes. There are also references to changes made in the water sector, but these were strongly resisted by companies and time will tell whether the changes strengthen or weaken financial resilience through reducing flexibility for companies and unintended consequences.

#### **Ofgem's Proposed Changes**

6.9. In terms of the specific potential financial resilience measures summarised in table 3 of the finance annex, SGN's view (as detailed below) is that overall, the measures are unlikely to make any material difference to financial resilience or consumers but will add to the administrative burden and costs to consumers:

- [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

- **Amend the dividend lock-up trigger to be the earlier of reaching BBB- with a negative watch/outlook and 80% regulatory gearing:** Ofgem needs to explain how the 80% figure was calibrated and why it considers that 80% is 'too high'.
- **Amend the availability of resources requirement to cover the remainder of the price control period or a minimum of at least 3 years:** While we see the benefits of setting out in a business plan the financial resilience plan of the company for the whole price control period and monitoring against this, there is no benefit in keeping liquidity for the whole period of 3-to-5 years ahead. Keeping liquidity for a 3-to-5 year ahead period would significantly increase the cost for consumers with a limited benefit. Indeed, the rating agencies generally consider liquidity on a 1-year ahead basis, as having an investment grade rating allows licensees ready access to the debt capital markets. As covering these additional liquidity requirements with drawn debt would be incredibly inefficient and costly, it is likely the bank market would have to provide forms of committed but undrawn liquidity, such as bridging loans, larger revolving credit facilities and letters of credit.

[REDACTED]

We would therefore request that Ofgem defines the problem that it is looking to address and undertakes an impact assessment of this option to establish whether the cost of holding liquidity for a 3-to-5 year forecast is greater than or less than the consumer benefits that would be expected to be generated.

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<sup>85</sup> Nera 'Additional Cost of Borrowing for the RIIO-3 Price Control', March 2024

We would also request that Ofgem sets out how networks should interpret this requirement as we cross regulatory period, as potentially there are only 2 years in every 5 where a 3 year forecast is not subject to a significant regulatory intervention. In our view, this is not in the customers' best interest as it will add disproportionate incremental cost to consumers.

#### Alternative measures

6.10. In terms of other measures, we would propose, we believe consistency in targeting a certain financial resilience threshold would be improved if a correct / comparable type of rating is used across companies. Currently the dividend lock-up is applied by selecting different ratings to act as triggers from the three different agencies:

- Corporate family rating (CFR) from Moody's
- Issuer credit rating (ICR) for S&P, and
- Issuer default rating (IDR) from Fitch

6.11. These ratings across the rating agencies do not measure the same things. Moody's defines its CFR as a loss given default, which effectively measures creditor recovery from a corporate entity in a hypothetical default. The recovery is measured at an entity level together with default probability. S&P and Fitch define their ICR and IDR, respectively, as the expression of probability of default only. Creditor recovery for a particular debt class represents another layer of analysis, which is then used to arrive at debt ratings by S&P and Fitch. For simple unsecured debt structures with just one class of debt, S&P and Fitch's debt ratings include recoveries in relation to the whole corporate entity and therefore are the most comparable measures of credit quality to that of Moody's: creditor recovery from the corporate entity as a whole.

6.12. It is acknowledged by the debt markets that Moody's CFR has a recovery component absent in S&P's and Fitch's ICR and IDR. While S&P unsecured debt rating is the same as its ICR, Fitch's unsecured debt rating benefits from a one-notch uplift to the IDR for the above-average recoveries observed in the regulated utilities sector. By comparing Moody's CFR to Fitch's IDR instead of the debt rating, Ofgem is introducing an inconsistency in the way it applies its dividend lock-up threshold.

6.13. Linking a dividend lock-up to the inconsistent measures across the three rating agencies creates confusion around the targeted level of financial resilience.

6.14. Types of credit ratings that consistently define creditor recovery at an entity level for the given debt structure:

Type of debt	Moody's	S&P	Fitch
Senior unsecured debt / simple vanilla debt structure	Corporate Family Rating	Unsecured Debt Rating	Unsecured Debt Rating

6.15. Fitch recently published their views on the SSMC and commented<sup>86</sup>:

*"Fitch applies a one-notch rating uplift above the issuer default rating (IDR) to debt issued by regulated utilities (or their guaranteed Fincos) in creditor-friendly jurisdictions with a robust regulatory environment, like the UK. Fitch's generic sector uplift is supported by above-average recovery expectations for regulated networks, in turn driven by fair regulatory frameworks and licencing ring-fence provisions (as is the case for Ofgem). Furthermore, the valuation of regulated utilities is much clearer, supported by the known RAV."*

*We believe that the senior debt rating<sup>1</sup> (rather than the IDR<sup>2</sup>) would be a more appropriate rating to monitor, to factor in recovery considerations and to allow better comparison with the ratings of other agencies (where rating definitions may vary)."*

- 6.16. Para 6.11 of the SSMC Finance Annex states there could be potential shortfalls or disadvantages of the existing measures, particularly in changing environments where companies are materially growing or shrinking. SGN believe that the best way of ensuring the financial resilience of GDNs is managing the downside asymmetric risk of the Future of Gas scenarios through the assurance that the RAV and ongoing costs will be recoverable as set out in our response to FQ21.

**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?**

- 6.17. **As detailed in our response to FQ15 we believe existing powers are sufficient. It has not been clearly established (i) that the consumer benefits outweigh the costs of implementing such changes, (ii) what market failure that any new changes are targeting to address (iii) that the proposed changes are consistent with Ofgem's duties. Therefore, we believe any introduction of new regulation should, following good regulatory practice, be targeted at the specific market or regulatory failure. Existing failures relating to excessive leverage should first be identified and then an impact assessment made considering the proposed remedy before introducing new regulations.**

**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?**

[REDACTED]

[REDACTED]

[REDACTED]



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?

- 6.24. As detailed in our response to FQ15 we are unclear what problems the stress testing is trying to test. The risks faced by network energy companies are different to the retail sector and banks and therefore this is unlikely to be valid comparison. However, we do take financial resilience very seriously and if an impact assessment shows that some form of stress testing is in consumer interests compared to the cost and burden imposed by the amended RIGs, then we remain open minded.

## 7. Section 7. Corporation tax

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

- 7.1. Overall, we agree with the proposal to align the RIIO-3 tax approach with RIIO-2. However, it needs to be made clear the tax review process is symmetrical, i.e., that it applies if tax allowance is incorrectly below actual tax as well as above. This is also a Financial Resilience consideration in terms of having financeability protection against allowed tax being incorrectly materially below actual tax.
- 7.2. As an example, the SSMC states<sup>87</sup>;

*'The [tax allowance adjustment] 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'.*

<sup>87</sup> [RIIO-3 Sector Specific Methodology Consultation – Finance Annex \(ofgem.gov.uk\)](#), para 7.3.

- 7.3. This does not suggest a symmetrical mechanism that protects networks as well as customers. Furthermore, it is important to note that there is a Financial Resilience consideration in terms of having financeability protection against allowed tax being incorrectly materially below actual tax.

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

- 7.4. **Ofgem propose a change in RIIO-3 to include cumulative accretion (net of paydown) in the regulatory definition of net debt, to calculate gearing for the tax clawback calculation. This is clearly a complex area, and we suggest that the tax clawback methodology for RIIO-3 is reviewed by the Ofgem-ENA Tax Working Group.**

## 8. Section 8. Regulatory depreciation and economic asset lives

### 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?

- 8.1. **We welcome the position Ofgem has taken that it is not in consumer interests for asset stranding risks to sit with investors (as per para 1.7 and 8.15 of the Finance Annex). However, we also note that the mechanisms that could be deployed to ensure this is the case, with the exception of accelerated depreciation, would require government decisions and are therefore ultra vires for Ofgem at this stage.**

- 8.3. **In fulfilling its regulatory duties, it is incumbent on Ofgem to push and advocate for collective solutions, but also, in the absence of such certainty, to recognise the risk that exists now and to ensure that this is accounted for in RIIO-3. Indeed, the ongoing risk will need to be factored in as a risk premium that is already demonstrable in recent debt transactions and for equity the concept of investability concerns driven by uncertainty and risk will need to be quantified and remunerated appropriately in the Cost of Equity.**



[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

8.6. It is therefore very important that there is a highly strategic discussion across Ofgem, DESNZ, Treasury and investors about how to ensure that the transition is delivered in a fair and equitable manner where efficient costs necessary for safety and security of supply can be recovered in a progressive way. We would like to support such a discussion.

8.7. Essentially what is needed is an 'insurance policy' that protects both customers and investors in the rapid disconnection scenario, and there is no necessity for this to come with any costs for consumers at this point.

8.8. We do not see this as a pre-requisite to have resolved for the start of RIIO3, but it is important that there is a very clear commitment to provide assurance to investors in the RIIO3 Final Determination that the investment and ongoing costs will be fully recovered and to progress this issue during RIIO- 3.

8.9. Therefore, in the absence of such investor certainty, the ongoing risk will need to be factored in as a risk premium that is being perceived and demonstrated in recent debt transactions and for equity and, the concept of investability concerns driven by uncertainty and risk will need to be quantified and remunerated appropriately in the cost of equity.

[REDACTED]

8.11. Until there is a government decision on heat, the government position can change and DESNEZ and treasury need to be engaged on the consequences of this decision and the reassurance required now for gas investors in order to ensure that regulators are responding to the evidence showing that this is already impacting the investability of the sector as illustrated in our response to FQ14. Starting dialogue with Government now would mean there is no requirement for a re-opener.

8.12. 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?

8.13. **As stated in our response to FQ21, we believe accelerated depreciation is not the optimum way to implement a flexible cost recovery mechanism from consumers and that there needs to be a much broader and more holistic debate to assess the impact of alternative scenarios and their social implications. Safety related investment will be required to keep our customers and the public safe, this will provide an ongoing need for investment until a point of committed de-energisation. We do not consider the FES scenarios to provide a sufficiently robust assessment of when de-energisation will take place to form the basis of a regulatory depreciation policy.**

#### **Long term pathway**

8.14. Current market evidence of customers willingness to adopt heat pumps as a replacement to their current gas heating system is very poor. The current observed installation rates of heat pumps<sup>88</sup> are only 17% of the installation rate forecast for 2023 under 'falling short' scenario and 8% of the installation rate forecast under their 'leading the way' scenario.

8.15. With just over 12,845 low carbon boiler upgrade voucher redemption requests received in 2023, of which approximately half were to come off gas<sup>89</sup> so approximately 6,000 a year of which we would expect a quarter (1,500) to be on SGN's network. With 6 million customers on SGN's network alone the current rate of heat pump uptake suggests that it will take 4000 years for all the customers to convert to heat pumps and to migrate away from the gas network.

8.16. Given these uptake rates it would be very difficult to determine an optimum rate of accelerated depreciation that appropriately balances the needs and costs incurred by current and future generations. As suggested by Ofgem's policy aims stated in the finance annex (para 1.9):

*"Consumers tomorrow do not pay a significantly higher charge for deriving materially the same value from their use of the gas network (i.e., our policy promotes fairness between current and future consumers); and*

*Consumers today pay no more than is necessary (i.e., to avoid having to compensate for any misperception of asset stranding risk in the weighted average cost of capital (WACC))."*

8.17. Until there is a clear sustainable customer lead pathway, we believe that it is premature to increase bills significantly to customers today on the basis of something that may happen. At the same time, we recognise that there is a legal obligation on the government to deliver net zero by 2050 and therefore we should anticipate new policies being introduced that will drive change, there will also be new technologies introduced that make that change more amenable and less disruptive to the consumer.

#### **Unit Metrics**

8.18. SGN also believe that the current FES scenarios are implausibly optimistic on their assumptions about the uptake of heat pumps to be considered a reasonable forecast on which to base regulatory decisions that will impact the cost to our customers. Rather, it is important that leading indicators are established to help determine the pace of change. We would suggest that this should be a leading indicator based on

<sup>88</sup> [Boiler Upgrade Scheme statistics: December 2023 - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/statistics/boiler-upgrade-scheme-statistics-december-2023)

<sup>89</sup> [Boiler Upgrade Scheme statistics: December 2023 - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/statistics/boiler-upgrade-scheme-statistics-december-2023)

the number of heat pumps (or other technologies) that are installed in homes with an existing gas connection.

- 8.19. The lagging indicator to verify these figures should then be the number of homes that have disconnected from the gas network. Such an indicator would then demonstrate not only whether a technology has been installed but whether the customer is still utilising gas for other reasons (cooking, etc).
- 8.20. The reason for focusing on the lagging indicator is that it is only once all customers disconnect from a section of network that we can de-energise that section.

[REDACTED]

[REDACTED]

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

- 8.22. As stated in our response to FQ21, we believe accelerated depreciation is not the optimum way to implement a flexible cost recovery mechanism from consumers. We believe dialogue should start immediately with Ofgem, Government and Stakeholders to develop the management of this risk more holistically with a commitment to protecting investors (which we believe is also in consumers best interests). Therefore, there is no requirement for a re-opener.

**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?**

- 8.23. Until there is a degree of certainty regarding asset repurposing, which is likely to be far into the future and subject to so many variables, the likely value cannot be predicted with any reliability. Therefore, SGN believe it would not be prudent to add another risk variable, on top of network usage, into the assessment of asset stranding and cost recovery risk. As stated in FQ21, a commitment to a government backstop would eliminate the need to assess these uncertain variables now.

[REDACTED]

- 8.25. Until there is some degree of certainty, SGN cannot see what further guidance could be provided in the SSMD and we should continue to model the current depreciation methodology.

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.

8.26. **We do not have any visibility of ET Business Plans so cannot comment.**

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?

[REDACTED]

8.28. **Any decision on 'semi nominal' cost of debt and WACC would not change our position on accelerated depreciation or justification for a commitment to provide a backstop to asset stranding and cost recovery risk.**

## 9. Section 9. Return Adjustment Mechanisms (RAMs)

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

9.1. **SGN would support RAMs being continued in RIIO-3, as in principle they protect consumers and companies for extreme circumstances.**

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?

9.2. **It is too early in the price control process to comment on whether the RAMs methodology should be adjusted for factors such as recalibrating the thresholds for rates or including financial performance. This design and calibration need to be consulted on once the whole price control package is known, for example the treatment of inflation in setting the allowed cost of debt or the uncertainty mechanism package.**

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?

- 9.3. For GDNs our initial thinking is that we believe if there is material reopener/government policy change, such as on heat policy, then the impact of this reopener could be included in a separate RAM due to a potentially different risk profile than core totex.

## 10. Section 10. Other finance issues

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

- 10.2. [REDACTED]
- 10.2. Within the RIIO-2 price control, the two-bucket capitalisation rate approach was not flexible enough to manage differing capex/opex splits that occurred within IT related re-openers. As there were a number of Cyber / non-operational IT re-openers during the RIIO-2 period, this has caused a difference in the natural capitalisation rate and the regulatory set view.

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?

- 10.3. **SGN believe an outturn capitalisation rate should be adopted, as this should reduce the risk of detrimental cashflow, and credit metric impacts currently caused by not updating ex ante capitalisation rates for actual totex. We indicatively support option D in para 10.9, i.e., reporting an outturn capitalisation rate for overall actual totex. However, it needs to be considered whether option D still leaves an avoidable cashflow and credit metrics risk and further detail is required on the options before any firm decisions are made.**
- 10.4. SGN believe an outturn capitalisation rate should be adopted, as this should reduce the risk of detrimental cashflow and credit metric impacts currently caused by not updating ex ante capitalisation rates for actual totex. Our understanding is that this would rule out options A and B in para 10.9 due to them using ex ante capitalisation rates (either 2 tier or by multiple buckets).
- 10.5. Although using outturn capitalisation rates, we understand option C would also be a multiple bucket approach, i.e., using an outturn capitalisation rate by uncertainty mechanism/component of allowed totex. This would be very complex to model or follow, and presumably calculating an outturn capitalisation rate by bucket would ultimately lead to the same amount of overall fast and slow money vs using an overall Totex outturn capitalisation rate as per option D.
- 10.6. This leads us to indicatively supporting option D but, whilst we appreciate a brief discussion of the issues on the 11th of January 2024 Finance Working Group and the high level stylised examples shared, further detail is required on the options before any firm decisions are made.
- 10.7. While not called out specifically within the Finance Annex, considerations of changes to capitalisation rates will also need to be made for the Cost Benefit Analysis approach. If it is decided to adopt a more

natural capitalisation rate, then this will need to be calculated within the CBA model options and may become a further factor at play which could impact payback periods.

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

- 10.8. **We believe that due to the fast-changing environment regarding delivering net zero, that it is timely for Ofgem to look at whether the current rules around directly remunerated services best support net zero delivery across the sector. This could include categories of work (See FQ33) or rules around de minimis work.**

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

- 10.9. **Given the downside risk and uncertainty facing GDN's, there may be value in conducting more consented or de minimis activity if utilisation of the network falls, but assets are still required. We believe it is in everyone's interest to some incentivise efficient utilisation of assets and workforce.**
- 10.10. **As mentioned in FQ32 one area to consider would be around any extra work activities through the evolution of the HTBM. At this stage we are not aware of any specific extra categories that would be required but believe Ofgem should be flexible on changes within the price control period.**

**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?**

- 10.11. **We believe the intergenerational consumer case for change is not strong enough to justify the potential revenue volatility and credit metric impact that treating all disposals as fast money would have. Therefore, unless there is a stronger consumer driver that outweighs the material financeability concerns, we support retaining the existing policy.**

**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?**

- 10.12. **The collection of information via the RFPR or other mechanisms must be proportionate to the demonstrable benefit it has to future decision making. If changes to reporting meets this test, then we would be supportive. We believe the task of identifying relevant information and the cost / benefit of this should be delegated to the cost assessment working groups.**

**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?

- 10.13. We believe that Ofgem already has a comprehensive suite of obligations and mechanisms in place and encourage Ofgem to clarify the concerns that they are looking to address. We note that revised policy has only been in place for one year and that it may be more appropriate to ensure that the updated guidance is applied appropriately and consistently before introducing further changes.

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

- 10.14. We believe the RIGs consultation later this year is the appropriate forum.

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?

- 10.15. SGN do not feel that the PCFM requires major changes. One area of improvement would be with greater visibility of adjustments to prior year revenues for stakeholders as well as movements from the previously published PCFM. The current version does not provide stakeholders with visibility of a breakdown of these figures, which can be material.



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?

- 10.16. SGN would be supportive of licenses self-publishing the ART, which is similar to the process undertaken for GD1. However, were this to be the case, we would like to tailor the AIP dry run process to only submitting a PCFM at the beginning and end of the process. The first one would be submitted in July, along with the RRP submission. This version would contain all prior year actuals, these figures would be Ofgem's only primary focus, ensuring consistency with RRP inputs. The second (and final) version, submitted in either mid-December or early January, would also contain forecasts Ofgem provide networks (WACC/inflation/ RPEs, etc., if still supplied by Ofgem), and other forecasts outside of Ofgem remit (pass-through, totex, other revenue, incentives, etc). The current process puts unnecessary burden on both networks and Ofgem, and results in a bottleneck to the process of the forecasts provided by Ofgem.

**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?**

- 10.17. **Our position has not changed from that adopted by Ofgem of RIIO-GD2/T2, i.e., that WACC should be applied to revisions to PCFM inputs whilst a Cost of Debt figure should be applied to k correction (under/over recovery errors). We understand the application of a single time value of money adjustment is being driven by a proposal to combine the ADJ and k terms into one. We understand these terms are combined in the RIIO-ED2 PCFM, but we are not sure of the advantages of this. This is because not separately seeing changes in the total amount of allowed revenue networks are allowed to collect, and timing of collecting that revenue, seem fundamental to the transparency of the process (as set out in our response to FQ38).**
- 10.18. We believe a bank rate plus margin is more suitable when a company can be reasonably expected to accommodate the movement of relatively minor cashflows across years via a short term bank facility or equivalent, i.e., when it has made an under/over recovery. In contrast a nominal WACC should be applied to prior year adjustments when timing adjustments entail a more substantial commitment +/- take effect over a longer duration, e.g., when investment expenditure is not known when allowances are set ex ante at FD, including reopeners and uncertainty mechanisms.