

Call for input

Energy Networks Ring-fence Review Call for Input Conclusion

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Publication of our conclusion and next steps on the energy networks ring-fence review call for input.

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1. Introduction

- 1.1** On 18 September 2024, we¹ published a Call for Input (CfI) on the 'Energy Networks Ring-fence Review', with a response deadline of 18 November 2024.² The CfI sought input from stakeholders on a proposal to review the energy networks ring-fence³. We are grateful for the engagement we have had from a range of stakeholders on the ring-fence to date.
- 1.2** The CfI outlined the key licence condition amendments proposed within the RIIO-3 Sector Specific Methodology Decision (RIIO-3 SSMD) Finance Annex⁴ which were relevant to the ring-fence. In addition, the CfI identified further areas for improvement to licence conditions which we seek to consult on as part of the review.
- 1.3** We have concluded our review of the responses, non-confidential copies of which are being published alongside this document. Respondents were composed of: eleven network companies and the Energy Network Association (ENA), six independent network companies and the Independent Network Association (INA) and Citizen Advice. Within this document we will set out a summary of responses and our next steps in respect of this review.

¹ References to "Ofgem", "the Authority", "We", "Us" and "Our" are used interchangeably in this document to refer to the Gas and Electricity Markets Authority.

² [Ring fence review: energy networks call for input - Ofgem - Citizen Space](#) Please see also the call for input document here: [Energy Networks ring fence review](#)

³ Unless otherwise specified, we use the term "ring-fence" to refer to the regulatory ring-fence throughout this document.

⁴ [RIIO-3 Sector Specific Methodology Decision – Finance Annex](#) and [RIIO-3 Sector Specific Methodology Decision – Overview Document](#) ([ofgem.gov.uk](https://www.ofgem.gov.uk))

2. Summary of responses

2.1 Number of responses

There were 20 responses to the CfI in respect of the Energy Networks ring-fence review. Respondents were composed of: eleven network companies and the Energy Network Association (ENA), six independent network companies and the Independent Network Association (INA) and Citizen Advice.

2.2 Key themes

We have provided a summary of key themes raised by respondents below. Please note individual responses vary by stakeholder.

2.2.1 ENA and Networks

- The majority of respondents were in support of a review provided it was targeted and evidence-based.
- The majority of respondents recommended a holistic approach be taken.
- The majority of respondents stated further amendments, as a result of the ring-fence review, may cause a significant rise in costs to network licensees⁵ and consumer bills.
- Under half of respondents stated further intervention was unnecessary and may add regulatory burden.
- Over half of respondents stated the cost of equity or cost of capital may increase as a result of further ring-fence measures.
- A minority of respondents raised a concern that the proposed ring-fence review and in particular, higher intervention measures may worsen any financial distress in network licensees.
- A minority of respondents were against the proposed change in reporting period for Availability of Resources (AoR) certification.

2.2.2 Citizens Advice

- Stated it was timely that Ofgem should be reviewing the ring-fence arrangements for network companies.

⁵ References to “licensees”, “network companies” and “network businesses” are used interchangeably in this document.

- Stated they were aware that ownership structures of network companies were becoming increasingly complex which can introduce risk for consumers.
- Were supportive that Ofgem seeks to address the strength of dividend lock up, clarity of restrictions on disposals, inconsistencies across sectors and obligations which may be open to interpretation.

2.2.3 Independent Network Operators and INA

- Noted while there may be good reason for additional requirements for networks, there are currently no ring-fence weaknesses apparent to the independent networks and that many of the proposed changes would not be applicable to the independent sector. For instance, one independent network noted that Moody's may be the only credit rating agency which has a methodology which is capable of measuring credit worthiness of independent networks businesses.
- Stated their business model is fundamentally different from RIIO network businesses as they are not funded through a price control.
- Felt strongly the current arrangements that apply to the independent network businesses should remain in place.

2.3 Call for Input (CfI) – Stakeholder responses

2.3.1 Frequency of review

There was general consensus for a review of the ring-fence, with 80% of CfI respondents supporting a review to be undertaken to encourage the financial resilience of the sector. The respondents noted that the review should be proportionate, targeted and evidence based. There were differing views regarding the frequency for a review of ring-fence conditions. One respondent stated Ofgem had already "examined the ringfence" through the RIIO-3 SSMD consultation.

Ofgem response

We agree with the CfI respondents that support a review of the ring-fence and consider a review is required to assess and potentially reduce the risks of financial distress in networks. The review should be proportionate, targeted towards areas of concern and evidence based. The objective of a review would be to consider areas where amendments to the ring-fence licence conditions would be beneficial in protecting consumers from harm now and in the future. We believe a review would facilitate investor confidence in the financial resilience of network businesses, as it would strengthen the protection of ring-fenced assets from the wider corporate

group and in our view should lower the perceived risk of financial distress in the licensee.

As the ring-fence has not been reviewed in some time, we consider it appropriate for us to carry out a review to ensure we are satisfied that our ring fence arrangements are fit for purpose. While we have made some financial resilience proposals through the RIIO-3 SSMD, we have not reviewed or formally consulted on the ringfence since 2010.⁶ In addition, financial resilience forms part of Ofgem's Multi-Year strategy⁷, which was issued on 28th March 2024, and includes the aim of "evolving existing financial resilience measures to ensure appropriate levels of protection are maintained for consumers".

2.3.2 Holistic approach

There was concern raised by 45% of CfI respondents that a ring-fence review may send a signal to the market which would make it harder for network companies to secure sufficient investment to support the transition to net zero. Therefore, respondents advised for a holistic approach to be taken by Ofgem, which takes into account financeability and investability.

Ofgem response

We agree that a holistic approach would be appropriate and anticipate any further amendments to strengthen ring-fence conditions should instil investor confidence in energy networks. This is particularly relevant in the context of the increased investment anticipated during the transition period to net zero.

2.3.3 Significant rise in costs

There was concern raised by 45% of CfI respondents that the outcome of a ring-fence review may result in significant rise in operational and administrative costs to network companies and which could impact consumer bills.

Ofgem response

We disagree that strengthening the ring fence will result in a significant rise in operational costs as we are looking to predominantly strengthen existing requirements and so this should not result in a significant additional marginal cost. We acknowledge the concerns raised around costs and will work with network

⁶ [Review of the 'Ring Fence' Conditions in Network Operator Licences](#)

⁷ [Ofgem's multi year strategy](#)

businesses to ensure any proposals which may result in increased reporting or disclosure requirements are practical, proportionate and in the consumer interest.

2.3.4 No need for a further ringfence review

Further intervention, beyond the proposals in the RIIO-3 SSMD, was considered unnecessary by 40% of CfI respondents as they stated further amendments to ring-fence conditions would add to regulatory burden.

Ofgem response

We have already identified issues with the ring-fence conditions through our financial resilience work which we have proposed to amend through RIIO-3 SSMD. However, we have also identified areas for further improvement which would require a further review of the ringfence. Further improvements may be required to the licence conditions to provide clarity in the requirements and definitions. Any licence modifications made in relation to the findings of any ring-fence review will apply to all RIIO sectors including Electricity Distribution.

2.3.5 Cost of capital/equity

35% of CfI respondents stated further amendments to the ring-fence could impact the cost of equity with investors requiring a higher return to compensate for the perceived risk of higher regulatory interventions. Therefore, the financial return expected by investors may rise.

Along a similar vein, 25% of CfI respondents stated that a consultation on the ring-fence, which would result in higher intervention and increased regulatory burden may trigger financial distress in network companies attributable to a decrease in investor confidence.

Ofgem response

We do not agree that a review of ring-fence licence conditions would increase perceived risk to investors and therefore increase the networks cost of capital or that it would precipitate financial distress. A strengthening of the ring-fence should benefit the sector as a whole, with lenders viewing this action favourably. It is not Ofgem's intention to introduce any measures that would push up the networks' cost of capital. There is a potential risk that a network company failure may increase the cost of capital for the entire sector. We believe that ensuring the ring-fence is robust and fit for purpose should mitigate against this.

2.3.6 Availability of Resources (AoR)

20% of CFI respondents expressed concern for a change in the timeline for AoR reporting from twelve months to a minimum of three years. This timeline was viewed as more onerous and any requirement for networks to pre-fund for the length of the price control may incur additional cost of debt refinancing.

Ofgem response

The purpose of the Availability of Resources (AoR) licence condition is for the licensee to confirm it has sufficient resources to enable the licensee to carry on its regulated business responsibly and efficiently. Currently the licence condition imposes a requirement on the licensee to certify annually to the Authority whether or not the licensee is expected to have sufficient financial resources to carry on activities in the following 12-month period. This change to the licence condition was proposed as part of our RIIO-3 SSMD. We will explore the mechanics of increasing the period to a minimum of three years or the entire price control period through our RIIO-3 licence drafting and Draft Determinations process. It is reasonable to expect companies plan beyond a 12-month horizon, Ofgem does not anticipate network companies incurring significant additional costs in relation to this proposed change in the licence condition and the requirement is not for the licensee to pre-fund its business for that period but for us to have visibility of the licensee's medium-term plans.

2.3.7 External requirements are sufficient

15% of CfI respondents noted that companies are bound by Companies Act 2006 (CA2006) and UK Corporate Governance Code requirements, which already contain necessary safeguards against misuse of company assets, introducing measures beyond this may be disproportionate.

Ofgem response

We disagree that current legislation is sufficient to protect the assets of a regulated entity. While the CA2006 provides some protection, this has not prevented financial distress occurring in regulated businesses. As a regulator, our principal objective is to protect the interests of existing and future consumers. While we acknowledge we are unable to eradicate the risk of financial distress, our aim is to mitigate against this risk as far as our powers allow. Therefore, a higher bar may be appropriate to protect regulated assets.

2.3.8 Differences between the energy networks and water/other sectors

35% of CfI respondents noted that the water sector or other sectors may not be appropriate comparators for energy networks, as arrangements implemented by other regulators have not been as robust as Ofgem.

Ofgem response

While the absence of any energy network failures to date is positive, as a regulator we have a duty to review existing arrangements and be proactive to mitigate risk of a network business failure in the future. Consultation on appropriate measures to prevent consumer harm may be more effective than an after-the-event response, which would be more costly. We noted in the SSMD that there is some evidence of potential harm to network businesses, coupled with the distress experienced in other regulated utilities, which indicates that this may be an appropriate time to conduct a review of the ring-fence.

3. Next Steps

- 3.1** The CfI outlined three potential options which could be adopted for the approach taken. Option 1, 'Maintain existing approach', was stated as preferred by over half of network company respondents. Option 3, 'Detailed review and targeted approach to strengthening the ring-fence', being the next preferred option, should Option 1 be unavailable. As Ofgem stated in the Call for Input, Option 1 is not considered appropriate, due to potential for consumer harm based on our initial assessment of network companies and events seen in energy retail and the water sector.
- 3.2** Following an initial assessment of financial resilience of network companies and consideration of the CfI responses received, we have decided to pursue Option 3, to carry out a detailed review and targeted approach to strengthening the networks ringfence. Having considered the feedback received, we have decided to exclude Independent Distribution Network Operators (IDNOs) and Independent Gas Transporters (IGTs) from the scope of this review. We will ensure that any new measures introduced will apply only to RIIO network companies. We may carry out a review of the independent networks ringfence requirements in future.
- 3.3** We intend to begin the review with a policy consultation in late summer of 2025 on the energy networks ring-fence followed by a statutory consultation to modify the licence conditions, where appropriate. This review will apply to all RIIO network companies including the Electricity Distribution Network Operators.
- 3.4** The RIIO-3 SSMD Finance Annex outlined three key measures to strengthen the financial resilience of the Gas Distribution and Transmission network companies. Since the publication of the RIIO-3 SSMD, evidence has come to light that further amendments may be beneficial in protecting consumers from potential harm of a network business experiencing financial distress or failure and it is these further amendments that we will take forward through the ring-fence review (RFR).
- 3.5** The SSMD Finance Annex sets out three financial resilience measures and the rationale for these.⁸ Further detail in relation to these measures will be included in the RIIO-3 Draft Determinations and any licence modifications in relation to these will be made through the RIIO-3 licence drafting working group process.

⁸ Please see table 16 in Section 6 of: [RIIO-3 Sector Specific Methodology Decision – Finance Annex](#) (ofgem.gov.uk)

3.6 At this stage, we believe a RFR to be in the interest of current and future consumers, to ensure the ring-fence is fit for purpose.

3.7 We propose to the following key areas may be within the scope of the RFR:

1. Availability of Resources
2. Credit rating of the licensee
3. Restriction on indebtedness
4. Independence of the network
5. Restriction of activity
6. Prohibition of cross-subsidies
7. Ultimate controller undertaking
8. Sufficiently Independent Director (SID) duties
9. Restriction on disposal of relevant assets
10. Transparency, inconsistencies and definitions

3.8 We are keen to engage with stakeholders throughout the review process and remain open to consider further evidence that stakeholders may wish to discuss with us.

Mick Watson

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